
Investment Manager Outlook

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Country: Australia

Synopsis: Russell's quarterly survey of
Australian investment managers
and their views of the market

About the Investment Manager Outlook

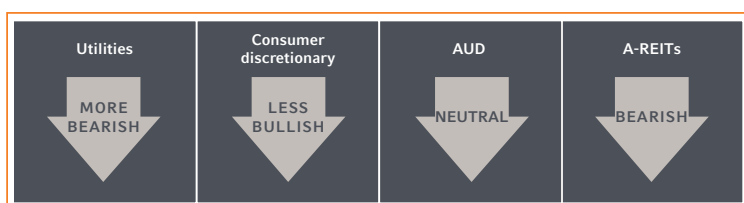
Welcome to the nineteenth edition of Russell's quarterly Australian Investment Manager Outlook, intended to generate a meaningful snapshot of Australian investment manager sentiment.

Because globally we conduct over 5,200 meetings with investment managers each year, following their careers and gaining their insights, we have extraordinary access to some of the world's best investment minds. These are the people that are worth knowing, and through the IMO, we bring you their knowledge and opinions so you can make decisions you or your investors will hopefully benefit from.

Each quarter, we survey around 40 of our Australian fund managers to collect their top-line opinions about the direction of the markets, their opinions on which sectors and styles to watch, and trends on the horizon that could affect your investment strategy.

Summary of key findings

Exhibit 1A: Biggest shifts – December 2009 Investment Manager Survey



Compared to survey results from September 2009 Investment Manager Survey, net balance basis.

Despite some sharemarket jitters and volatility at the start of the fourth quarter, fund managers remained overwhelmingly optimistic about the prospects for shares over the next twelve months. Almost three out of four held a bullish view on domestic shares, up from 65% in September – this despite only 18% of managers purporting that local companies remained cheap, down from 33% in September. The majority of respondents, at 66%, shared the view that Australian shares were at fair value, while 16% started to see signs that this year's rally had gone too far.

International shares continued to be the second most favoured asset class, with 52% of managers expecting a positive year ahead, compared with 58% in September. One third had a neutral outlook, perhaps unsure which scenario would play out in 2010 – aggressive growth consistent with a 'V' shaped rally, or a more sluggish outcome brought on by the longer-term fallout from the GFC.

The Reserve Bank's move to raise interest rates and its irrefutable signal that more hikes were on the way, did little to support sentiment towards the leveraged A-REITs. The proportion of bearish views rose from 23% in September to 42% this quarter. Australian bonds suffered a similar fate for a similar reason, with 71% of managers expecting the local bond market to decline over the next year, compared with 52% in September.

Cash on the other hand, while not quite king, certainly improved its standing among managers, owing to the prospect of rising yields with no corresponding capital losses. Bullish views have crept up from a historical low of eight per cent in June, through 22% in September, ending at a more healthy 33% in the fourth quarter.

The managers' view on the AUD was divided, despite our dollar averaging USD0.93 during the survey period – far above most purchasing power parity estimates. While 38% of managers viewed this as pushing a valuation extreme, the same proportion saw further positive prospects for the AUD. And with interest rates on the rise, continued support from offshore capital is certainly not out of the question.

Overall, shares continued to be the favoured asset class. Sentiment towards A-REITs and cash was on balance neutral, while Australian bonds remained the underdog for a third quarter in a row.

Positive sentiment prevails, but interest rates make a dent

By Scott Bennett, Russell Investments

Aussie shares win out again

The overwhelming vote of confidence extended to Australian shares last quarter was reaffirmed in Russell's December quarter survey of 44 fund managers. As Exhibit 2A illustrates, the net balance of manager expectations for the local market remained unchanged at a record high. However the composition of bullish and bearish views did vary subtly. In September, 65% of managers expected Aussie shares to rally over the ensuing 12 months, while in this survey, the number went up to 73%. At the same time, the proportion of bearish views also grew by 8%, to 16% in the December quarter.

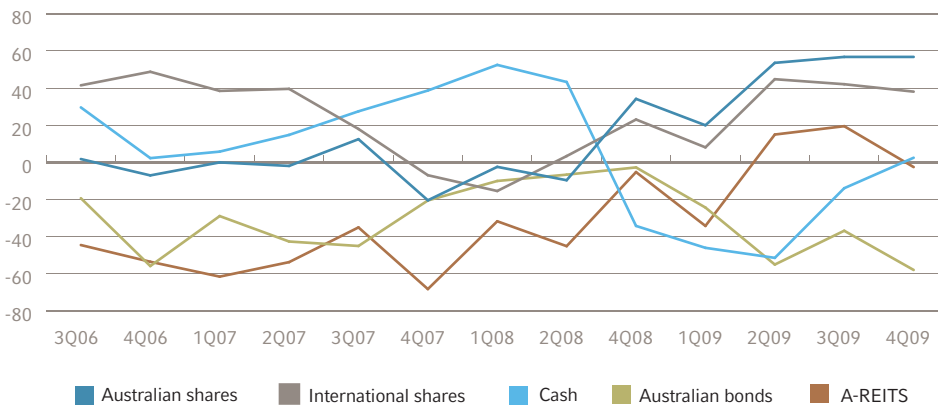
Managers appeared unmoved by the October hiccup in Australian share performance, taking it in their stride. Longer term expectations were firmly focussed on the positive prospects for our market, with the rosy vision reaching almost undisputed status. A new and significant player in the bullish camp was the Reserve Bank of Australia, raising interest rates twice and signalling further tightening underpinned by the local economy's resilience.

That's not to say that Australia is likely to completely escape the long-term fallout from the global crisis. But the downside will almost certainly be less severe than for the remaining G20 countries. And at the moment, that relative advantage is enough to sustain fund managers' optimistic sentiment towards Aussie shares – and international investors' demand for the AUD.

In terms of just how good 2010 is expected to be, 54% of managers predicted a return of 10% or more for the calendar year, underpinned primarily by strong earnings expansion. One in three was slightly less buoyant, foreseeing single digit growth over that period. At the other end of the spectrum, of the 14% anticipating a prolonged double dip, only 2% believed the fall was likely to be worse than 10% over the year.

“Managers appeared unmoved by the recent stall in Australian share performance. Longer term expectations are firmly focused on the positive prospects for our market and its fundamental resilience.”

Exhibit 2A: Net balances of manager expectations (bullish less bearish)



Positive sentiment prevails, but interest rates make a dent (continued)

Similarly to last quarter, two thirds of the surveyed managers shared the view that our market was at fair value. Managers with a bearish outlook for 2010 unsurprisingly tended to be the ones that saw Aussie shares as overvalued, comprising a 16% minority. Those viewing local shares as cheap have been consistently declining in number, from 59% of respondents in March down to 18% this quarter, in direct response to the strong market rally over the same period.

Industrials still leading the sector pack

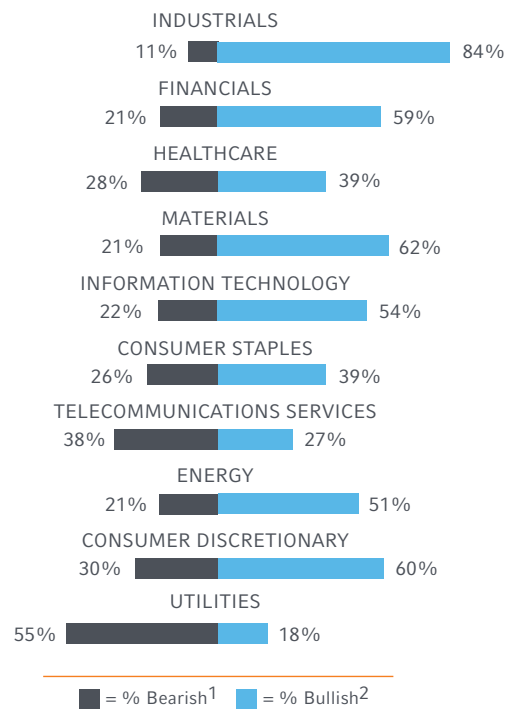
In the September survey, industrial stocks were the clear favourite among managers, with 69% expecting a positive 12 months ahead. That sentiment was reinforced in this quarter, with the proportion of bullish views rising to 84%, in line with strong economic recovery expectations.

The RBA raised interest rates twice between Russell’s third and fourth quarter surveys, with a clear intention of further hikes. As a result, high hopes pinned on consumer discretionary spending were notably tempered. The proportion of managers factoring in a decline for the sector was up from 9% to 30%, and bullish sentiment was down from 68% to 60% of managers. Little doubt appears to be cast over mortgage repayments making a painful dent in already stretched household budgets.

The materials sector, on the other hand, experienced a boost in sentiment. The sector has struggled in relative terms, losing close to half of its market capitalisation in the second part of 2008, and again underperforming during this year’s rally. The managers’ outlook for resource stocks has been quite volatile but in this quarter it was firmly etched in bullish territory, backed by 62% of respondents.

Similarly to last quarter, the two sectors for which the outlook remained weakest were telecommunications and utilities. In both cases managers further downgraded their expectations since September. Pessimism towards utilities reached the survey’s all time record of 55% of managers. The sector’s usefulness as a defensive play, which was very effective in latter 2008, was lost when the recovery story started to dominate investor preferences. While this continues, utilities will likely remain on the sidelines.

Exhibit 2B: Manager expectations by sector



Note: Bearish = percent of managers responding with 1–3 on a scale of 1–7. Bullish = percent of managers responding with 5–7 on a scale of 1–7. Scores for neutral (4) are not included. Rounding errors may occur. See detailed charts on the following pages.

Positive sentiment prevails, but interest rates make a dent (continued)

The interest rate effect

Sentiment towards asset classes other than shares appeared heavily influenced by the interest rate effect. The change in the RBA's tack from an easing to a tightening stance had a noticeable impact on the managers' outlook for the affected asset classes, namely A-REITs, Australian bonds and cash.

For A-REITs, interest rate rises were not good news. The highly leveraged property trusts sector – while on balance successful at keeping its debt ticking along thanks to extensive capital raisings – will likely experience further pressure from higher borrowing costs. Many trusts have a fine balancing act in place that enables them to service their debt, but it wouldn't take an awful lot to upset that balance. As a result, the proportion of managers with a bearish view on A-REITs went up from 23% in September to 42% in this quarter's survey.

Bonds are expected to be similarly disadvantaged, as the inverse relationship between yields and prices plays out. The majority of managers, at 71%, saw no upside over the next 12 months. Only 13% were still bullish, most probably hanging their hopes on further credit spread tightening.

Cash was the only benefactor of the rate rises, propped by the prospect of higher yields with no corresponding capital losses. Managers' bullish views have quadrupled since June this year, up to 33%. The bearish outlook has been steadily waning at the same time, down from a high of 65% in March to 30% in this survey.

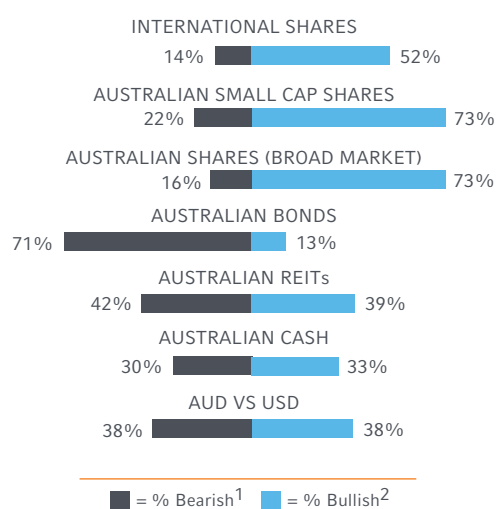
No consensus on the AUD

In June, conviction that the AUD would continue appreciating was at a record high for the survey. That was when the dollar averaged USD0.80. The AUD then crept up to USD0.84 at the time of the September survey attracting more sceptics, and to USD0.93 in this quarter.

The view on the future of the Aussie dollar is now split evenly, with 38% of managers calling USD0.93 the upper bound for the next 12 months, while the same proportion were seeing further upside. Interestingly, despite the two recent interest rate rises, the AUD appeared quite well anchored suggesting that the RBA's tightening could already be priced into the market. The managers didn't appear sure either way.

In summary, Australian managers maintained their positive outlook, with shares expected to provide the most upside over the next 12 months. The start of the interest rate tightening cycle remains a watch point, with the most affected market sectors experiencing a shift in manager sentiment.

Exhibit 2C: Manager expectations by asset class



Note: Bearish = percent of managers responding with 1–3 on a scale of 1–7. Bullish = percent of managers responding with 5–7 on a scale of 1–7. Scores for neutral (4) are not included. Rounding errors may occur. See detailed charts on the following pages.

Please refer to pages 11-12 for asset class definitions and page 13 for bearish & bullish definitions.

RESULTS

Valuation of the Australian sharemarket

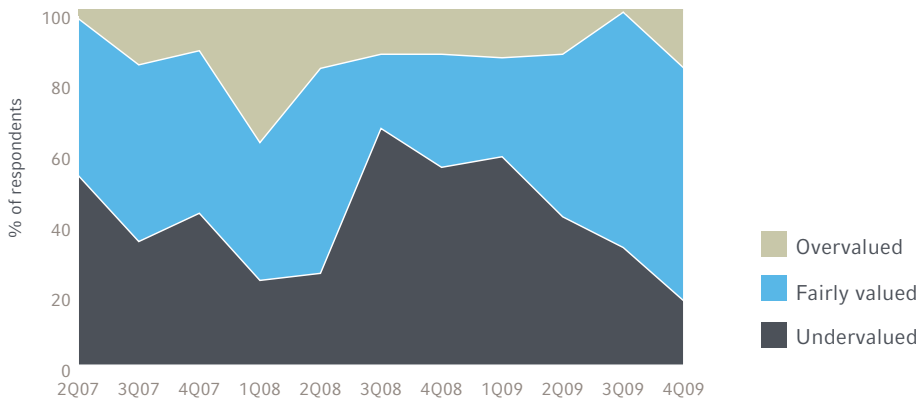
Question 1:

Which of these general valuation conditions best describes the current Australian sharemarket?

Key findings:

- › Just 18% of managers indicated the Australian sharemarket was undervalued; the lowest proportion since June 2008.
- › The ratio of managers viewing the market as fairly valued has remained unchanged since September quarter, at two in three managers.

Exhibit 3A: Shifts in market valuation



Note: Numbers may not add to 100 percent due to rounding.

“The overall outlook is mixed, but for Australia and our region, it is particularly strong. A substantial amount of the positive outlook is already priced into markets but moderate further price improvements in equities, listed property etc, can be expected as the reality of this outlook continues to be confirmed.”

IAN MACOUN
Pinnacle Investment
Management

RESULTS

Asset class expectations

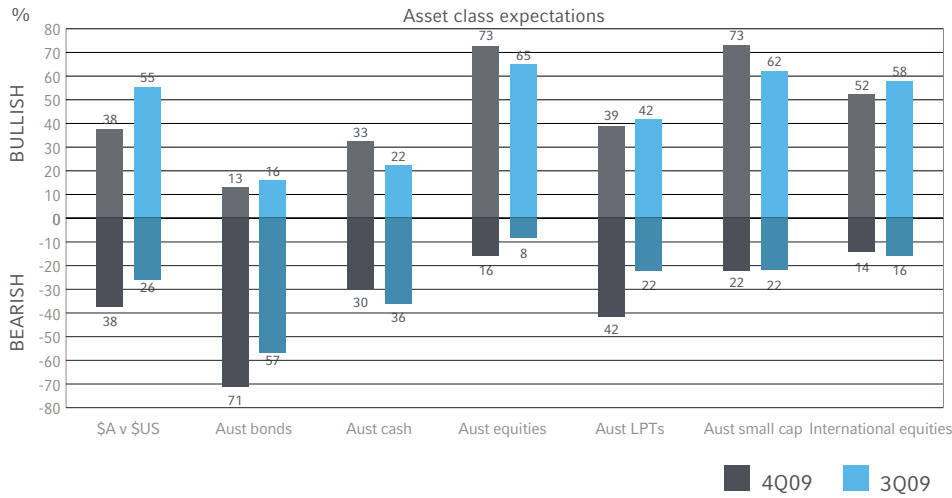
Question 2:

What are your expectations for the performance of the following asset classes over the next 12 months?

Key findings:

- › Managers continued their bullishness on Australian shares. For the second quarter in a row, managers were more bullish than ever on the asset class.
- › Sentiment with respect to Australian bonds was negatively impacted by the rising official cash rate. Conversely, the managers' outlook for cash benefited from the RBA's shift to a tightening bias.

Exhibit 4A: Manager expectations – asset classes



“The market is now looking at 2011 earnings which means the GFC no longer dominates. The biggest performance swing factor will hinge on commodity price performance, in turn dependent on the strength of the rebound in global industrial production.”

ANDREW SISSON
BEM

RESULTS

Sector expectations

Question 3:

What are your expectations for the performance of the following sectors over the next 12 months?

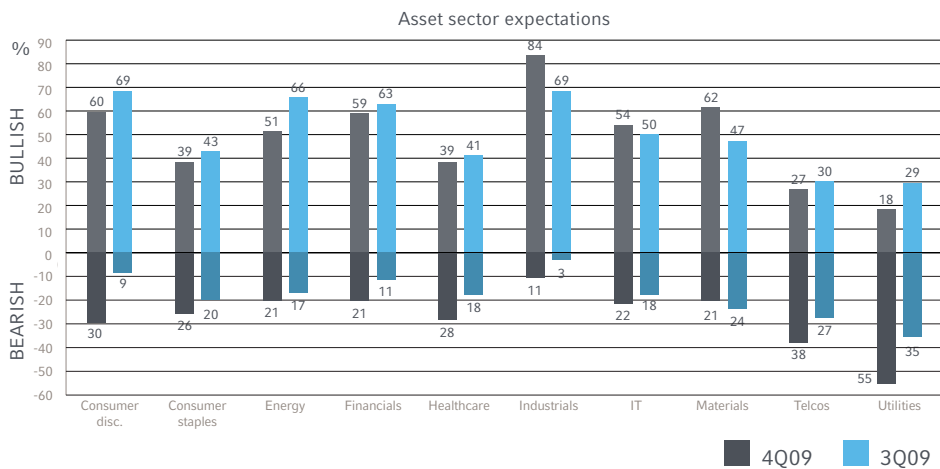
Key findings:

- › Industrials continued to dominate the positive outlook, while telcos and utilities remained the least-favoured sectors.
- › The bullish outlook for consumer discretionary stocks was tempered following two interest rate rises which are expected to impact household budgets.

Exhibit 5A: Manager expectations – Australian sectors

“Defensive shares have been left far behind in the recent rally. This is clear for the utilities sector which, whilst small relative to the market, is at a 10-year relative low.”

SIMON MAWHINNEY
Orbis



RESULTS

Sharemarket expectations

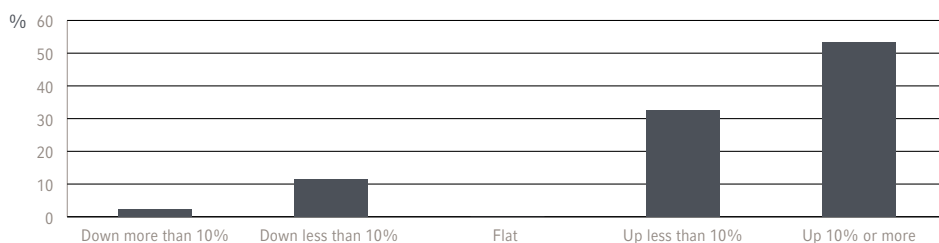
Question 4:

What are your expectations for the performance of the ASX 300 for the 12 months ending December 2010?

Key findings:

- › The majority of managers held an expectation that the Australian sharemarket would gain at least 10% over the year to 31 December 2010.

Exhibit 5A: Expected Australian sharemarket performance to end 2010



“Equity markets have rallied strongly in anticipation of economic and earnings recovery and valuations have been looking fair to full recently. We think that the equity market can deliver positive returns over the next 12 months as earnings growth re-emerges, although returns will be more modest and volatility higher than what we have seen over the past seven months.”

ROHAN WALSH
Portfolio Manager
Karara Capital

Methodology and about Russell Investments

Methodology

Russell Investments conducted the Investment Manager Outlook between 11 and 19 November 2009. The survey was sent to investment managers with a variety of investment focuses but is primarily made up of Australian large-cap, multi-cap and small-cap share managers, researched by Russell. Having a financial relationship with Russell was not part of the criteria for being included in the survey. In total, 44 investment management firms from Australia participated in the survey.

The large majority of individual respondents to the Investment Manager Outlook have senior-level investment decision responsibilities and are often portfolio managers or CIOs. Other participants included investment strategists, select research analysts, and others. The manager research that Russell conducts for investment purposes is done entirely independently of the Investment Manager Outlook, and responses to the survey are on a purely voluntary basis.

About Russell Investments

Russell Investments is a global investment management company that believes investors of all sizes can benefit from access to the world's leading money managers. To that end, we research, identify and select best-of-breed investment managers from around the world. We put those managers to work for some of the world's largest investors, financial advisers and individuals saving for retirement.

We provide sophisticated investment solutions including investment and superannuation funds, pensions, institutional asset management and implementation services, as well as our global shares indices.

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Founded in 1936, Russell Investments is a subsidiary of Northwestern Mutual and is headquartered in Tacoma, Washington, with additional offices in New York, Toronto, London, Paris, Singapore, Sydney, Melbourne, Auckland, and Tokyo.

Asset class definitions

Broadmarket Australian shares

Australian shares are a growth asset involving the purchase of ownership interests – and the rights to profit and voting that this implies – in a company listed on the ASX. Shares may be purchased from sectors including financial, materials, industrial and energy.

The risks faced by Australian shares investments include liquidity risk, market risk and company-specific risk; the value of investments is subject to changes to management, product distribution, investor confidence, internal operations and the company's business environment. The All Ordinaries Index, which represents around 99% of the Australian shares market, may be considered in assessing the risk profile of Australian equities.

Small cap Australian shares

A subset of Australian shares, small cap generally refers to companies with relatively small market capitalisation – below around \$2 billion. Small cap shares have some advantages over large cap shares including faster growth rates, faster response to changing market conditions and less agency concerns between management and shareholders. These investments provide the potential for strong growth over the longer term.

Small cap shares are inherently much more risky than large cap. Primary risks faced by small cap investments include rising interest rate risk, falling exchange rate risk and low liquidity. The ASX Small Ordinaries Index could be considered in assessing the risk profile of small cap Australian shares.

Australian real estate investment trusts (A-REITs)

A-REITs are collectively owned growth assets that invest in a portfolio of property. There are more than 45 A-REIT on the Australian Stock Exchange, primarily run by property management groups such as Lend Lease, Westfield and Deutsche Asset Management. A-REIT are a liquid, diversified investment providing an attractive yield in the form of annual or semi-annual dividends with some capital growth.

Risks faced by A-REITs include interest rate and market risk, security risk associated with property investment and distribution risk as dividends are not guaranteed by the A-REIT or ASX. The S&P/ASX 300 A-REIT Accumulation Index could be considered in assessing the risk profile of Australian property trusts.

Australian bonds

Australian bonds (or fixed interest) are a defensive asset providing debt capital to organisations in return for coupon payments and return of capital at expiry. Australian bonds may invest in a variety of sectors including government, corporate, international, semi-government and asset-backed. The sector chosen will determine, in part, the riskiness of the bond.

In general there is a negative relationship between interest rates and the value of bonds. The primary risks associated with Australian bonds include interest rate risk, inflation risk and credit risk. The UBS Australian Composite Bond Index could be considered in assessing the risk profile of Australian bonds.

Asset class definitions (continued)

Australian cash

Australian cash is a defensive, low-risk asset typically involving bank backed or short term securities. Cash provides diversification and liquidity benefits to a portfolio; however it generally provides lower investment returns than investments such as fixed interest, property or shares, and interest on cash investments has not kept pace with inflation in the past.

Aside from inflation risk, cash also faces interest rate risk as the prices of cash securities can fall as interest rates rise. The UBS Australian Bank Bill Index could be considered in assessing the risk profile of Australian cash.

International shares

International shares are a growth asset involving share investments in regions such as North America, Europe, Japan and UK. International shares have historically produced higher long-term returns than lower risk investments; however they tend to be relatively less liquid and more volatile than domestic shares.

International equities entail different risks than those typically associated with domestic shares, including currency fluctuations, political and economic instability, accounting changes and foreign taxation. The MSCI World Net Dividends Reinvested Accumulation Index could be considered in assessing the risk profile of International shares.

General disclosures

Performance quoted represents past performance and should not be viewed as a representation of future results.

1) We define bearish as...on balance, an organisation's or individual's predominant view based on a belief that general market conditions for the period in question will be negative, and relative valuations of securities in general will trend downward. This view should not be considered investment advice nor does it apply to any specific security.

2) We define bullish as...on balance, an organisation's or individual's predominant view based on a belief that overall market conditions for the period in question will be positive, and relative valuations of securities in general will trend upward. This view should not be considered investment advice nor does it apply to any specific security.

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