



Investment Manager Outlook

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 **VENTURA**

About the Investment Manager Outlook

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

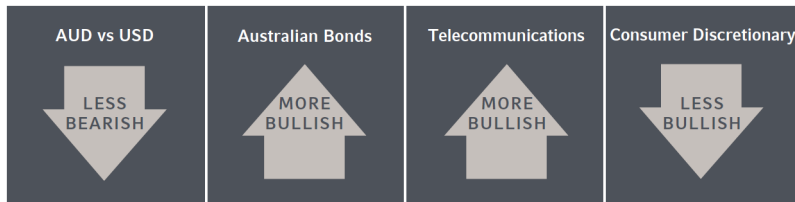
Because globally we conduct over 5,000 meetings with investment managers each year, following their careers and gaining their insights, we have extraordinary access to some of the world's best investment minds. Through the IMO, we bring you their knowledge and opinions so you can make decisions that will benefit you and your investors.

Each quarter, we survey around 40 Australian fund managers to collect their topline 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 - September 2011 Investment Manager Outlook survey



Compared to survey results from June 2011 Investment Manager Outlook survey, net balance basis.

Global and domestic share markets continued to weaken over the September quarter as market volatility spiked sharply higher in the wake of escalating European sovereign debt concerns and doubts about the sustainability of the US recovery. Greece remained the focal point of Europe's ongoing debt woes, though serious doubts were also raised over the fiscal positions of 'core' European nations such as Spain and Italy. Whilst European officials have moved to ease investor concerns by way of bond purchases and additional financial aid to the worst affected countries, political wrangling between the region's larger nations means a practicable and widely accepted resolution has yet to be determined.

In the US, softer jobs and manufacturing data suggested growth in the world's largest economy may have stalled, with investor sentiment further impacted by Standard & Poor's decision to cut its US government debt rating from AAA to AA+. Meanwhile, the US Federal Reserve (Fed) announced a further stimulus measure aimed at boosting economic growth. 'Operation Twist' will see the central bank use the proceeds from the sale of shorter-dated notes to buy longer-dated US Treasuries and mortgage-backed securities. The move is designed to significantly lower market interest rates, including those paid on mortgages and other forms of bank lending.

Here in Australia, investors also had to contend with increasing uncertainty regarding the implications of the Federal Government's carbon tax, the Reserve Bank of Australia's (RBA) decision to downgrade its near-term growth forecasts and further monetary tightening in China as officials there continue to battle rising inflation.

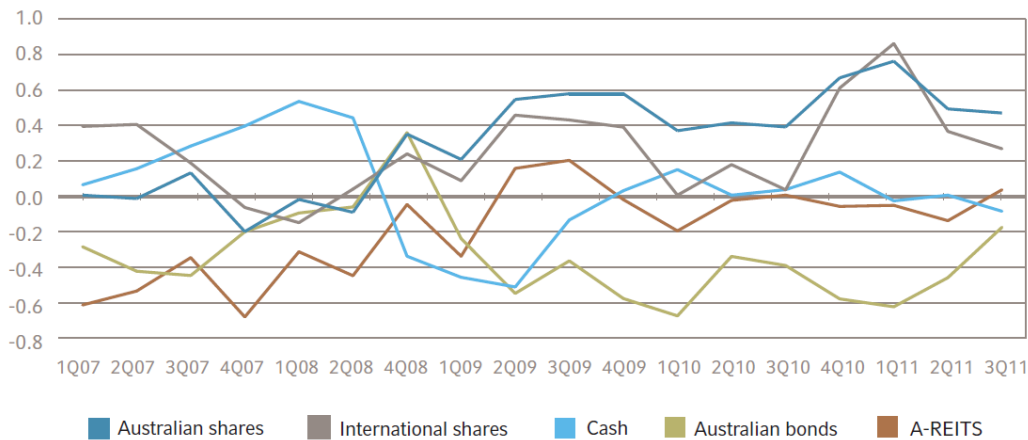
In this survey, we profile the way managers have amended their outlook in response to recent market events and where they see the best investment opportunities going forward.

"...market volatility spiked sharply in the wake of escalating European sovereign debt concerns and doubts about the sustainability of the US recovery."



Summary of key findings (continued)

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Risk aversion continues

The 'risk off' tone that characterised the last survey continued throughout the September quarter as increasing uncertainty regarding the outlook for global growth once again weighed on manager sentiment. As a result, managers largely maintained their preference for defensive assets, highlighted by a further rise (10%) in bullish sentiment toward Australian bonds. At the same time, bearish sentiment toward growth assets such as international shares and Australian shares increased by 10% and 6%, respectively. Consistent with the risk off environment, the Australian dollar (AUD) fell during the quarter and manager sentiment improved accordingly, with 15% more managers becoming bullish on the currency compared to last quarter. Meanwhile, managers were far less bearish on Australian real estate investment trusts (A-REITs), highlighting the more defensive nature of the sector following its recapitalisation in the wake of the global financial crisis. Exhibit 2A shows the net shift in overall manager sentiment over the quarter.

Australian share market undervalued

Managers remained more bullish on domestic shares (66%) than on international shares (57%), with an overwhelming majority (77%) believing the local market to be undervalued. By contrast, just 6% of all managers surveyed felt that Australian shares were overvalued.

"...managers largely maintained their preference for defensive assets, highlighted by a further rise (10%) in bullish sentiment toward Australian bonds."



Summary of key findings (continued)

Managers remain cautious

The recent trend in negative sentiment toward international shares continued throughout the September quarter, with 31% of managers now bearish on the asset class – ten times the number of managers who were bearish on the asset class at the end of the March quarter. The uncertainty caused by Europe's unresolved debt problems and the threat of a 'double-dip' recession in the US were largely to blame for the outcome. Further, efforts by US and European officials to address these concerns have so far had limited impact on improving market confidence.

Managers continue to prefer domestic shares to international shares given the Australian economy remains relatively well placed compared to its developed counterparts. The home bias also reflects the compelling valuations in the domestic share market as investors price in considerable downside risk and lower earnings expectations, relative to underlying fundamentals.

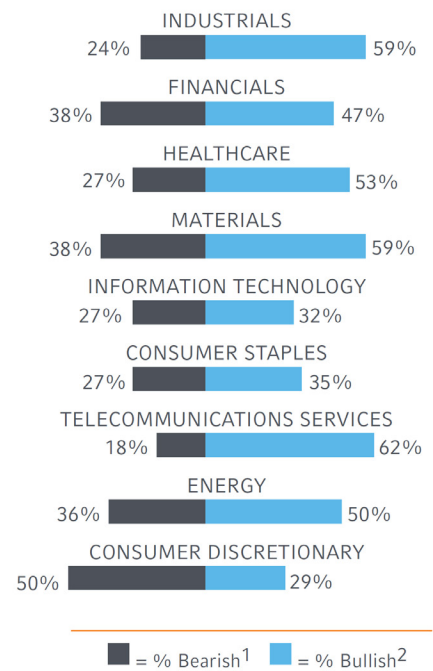
There was very little change in sentiment toward the domestic small caps sector over the quarter. Small industrials outperformed small resources as managers became more cautious on the latter in light of the softer outlook for global growth. Around a third of all managers surveyed are currently bearish on the small cap sector compared to 20% for the broader share market.

The RBA left the official cash rate unchanged at 4.75% for a third consecutive quarter. Despite some speculation of a near-term rate hike in the wake of a stronger-than-expected rise in June quarter inflation, the sharp spike in market volatility that began in early August eventually saw the market price in a series of rate cuts over the next 12 months. As a result, sentiment toward Australian cash turned relatively bearish, rising from 26% to 37% – its highest level since the September quarter of 2009.

The uncertainty caused by Europe's ongoing sovereign debt crisis and increasing doubts about the US recovery saw bullish sentiment toward Australian bonds rise from 19% to 29%. This outcome undoubtedly reflected a 'flight to safety' in the face of rising market volatility. Australian bonds continue to represent better value than international bonds, with the yield on US 10 year Treasuries currently trading below 2%. By comparison, the yield on domestic 10 year bonds continues to trade around 4%, in part reflecting Australia's AAA credit rating and relatively stable economy.

A-REITs continued to gain favour with managers throughout the quarter, with negative sentiment toward the sector falling to its lowest level in the survey's history (18%). A-REITs were well supported over the period by expectations of lower interest rates and the asset class's relatively defensive nature.

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.



Summary of key findings (continued)

The AUD lost ground against its US counterpart over the quarter, even falling below parity in the wake of Standard & Poor's decision to cut its US government debt rating. In our last survey, managers were particularly bearish on the AUD, believing it to be significantly overvalued. However, AUD weakness meant managers were far more favourable toward the currency this quarter, with bearish sentiment nearly halved from 62% to 37%.

Australian shares: Sector sentiment breakdown

Bearish sentiment toward the materials sector doubled from 19% to 38% over the quarter as uncertainty regarding the outlook for global growth and the threat of further monetary tightening in China continued to play on managers' minds. Likewise, the impact of slower growth on oil prices weighed on the performance of the energy sector, though sentiment was largely unchanged from last quarter.

The outlook for industrials improved significantly throughout the quarter, with 59% of all managers surveyed seeing value in the sector. This was up from 46% last quarter. What's interesting about this outcome is that sentiment improved despite relatively high interest rates, a stronger AUD and expectations of slower domestic growth. Instead, managers may prefer the sector because of strong cash flows, lightly geared balance sheets and sound business fundamentals. Valuations are also attractive relative to other sectors.

Consumer discretionary stocks were the least favourite stocks over the quarter, with exactly half of all managers bearish on the sector; up from 39% previously. Ongoing weakness in retail sales and softer domestic growth have contributed to this trend. Information technology was similarly affected, with positive sentiment toward the sector easing from 48% to 32%. By contrast, managers were most bullish on telecommunications (62%) because of the sector's defensive qualities in the face of rising market volatility. Financials were also more popular this time around, with positive sentiment toward the sector rising from 42% to 47%.

“Consumer discretionary stocks were the least favourite stocks over the quarter, with exactly half of all managers bearish on the sector...”

Australia's 'two-speed' economy: What will likely trigger a recovery in the non-mining sectors?

Much has been made of Australia's 'two-speed' economy over the past year, particularly the divergence in earnings growth and capital expenditure between the mining and non-mining sectors.

Despite the weaker outlook for global growth and the sharp decline in commodity prices (and hence resource stock prices) in the September quarter, the Australian resources sector continues to be driven by underlying demand for our raw materials. But whilst miners enjoy a once-in-a-lifetime purple patch of strong growth and positive earnings, and invest in a capital expenditure pipeline of mining and energy projects totalling more than \$170 billion¹, the rest of the economy is struggling against a backdrop of higher interest rates relative to the rest of the world, and a stubbornly high AUD, both of which are, ironically, the result of the mining boom itself.

1 Source: Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES)



Summary of key findings (continued)

In this latest survey, we asked managers about the divergence in performance between resources and the rest of the market, and what they believe will likely trigger a recovery in the non-mining sectors. The results, summarised in Exhibit 3A, show that the majority of managers (43%) believe lower interest rates will be the main catalyst for a recovery.

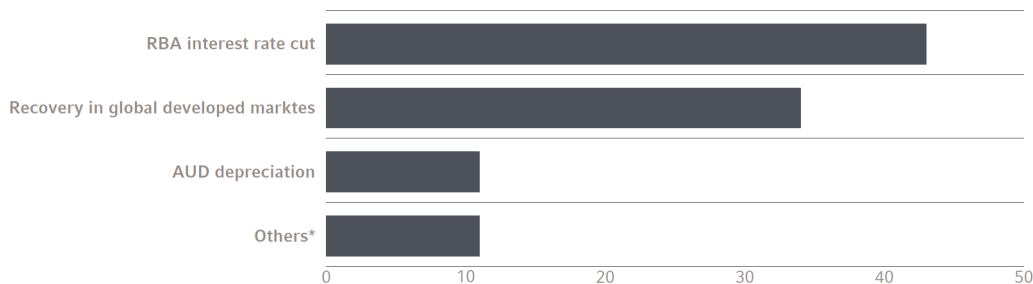
Australia is one of the few developed nations in the world to have raised interest rates in the wake of the global financial crisis as the RBA tried to find a balance between meeting its projected growth targets and containing inflation. Australia's official cash rate is currently 4.75%. This compares with 0.10% in Japan, 0-0.25% in the US, 0.50% in the UK and 1.50% in Europe. Higher interest rates relative to the rest of the world has made borrowing more expensive and this, combined with recent events in Europe and the US, is undermining confidence in the non-mining sectors. Importantly though, recent global turmoil has seen the RBA scale back its interest rate expectations, with the market now pricing in a series of rate cuts over the next 12 months.

Another potential trigger for igniting Australia's non-mining sectors is a recovery in global developed markets², with 34% of managers surveyed believing that improved stability globally would provide struggling domestic sectors with a significant boost in the form of greater consumer and business confidence. However, managers expect such a recovery could take at least 12 to 24 months.

Meanwhile, 11% of managers surveyed believed that a weaker AUD was the key to a turnaround in the fortunes of Australia's non-mining sectors. The AUD continues to trade at elevated levels and this is clearly putting pressure not only on manufacturers, but tourism operators, international education providers and other non-mining export businesses as well. A sharp and sustained decline in the AUD would likely encourage greater spending in these sectors, thus driving stronger growth outside of the mining industry.

"...recent global turmoil has seen the RBA scale back its interest rate expectations, with the market now pricing in a series of rate cuts over the next 12 months."

Exhibit 3A: Manager expectations - Triggers for recovery in domestic growth for the non-mining sectors (%)



² Russell also surveys US investment managers on their market insights. In particular, this quarter's US Investment Manager Outlook asked managers whether the US economy is entering a double-dip recession. A summary of the survey results can be found in the Appendix.



Results

Valuation of the Australian share market

Question 1:

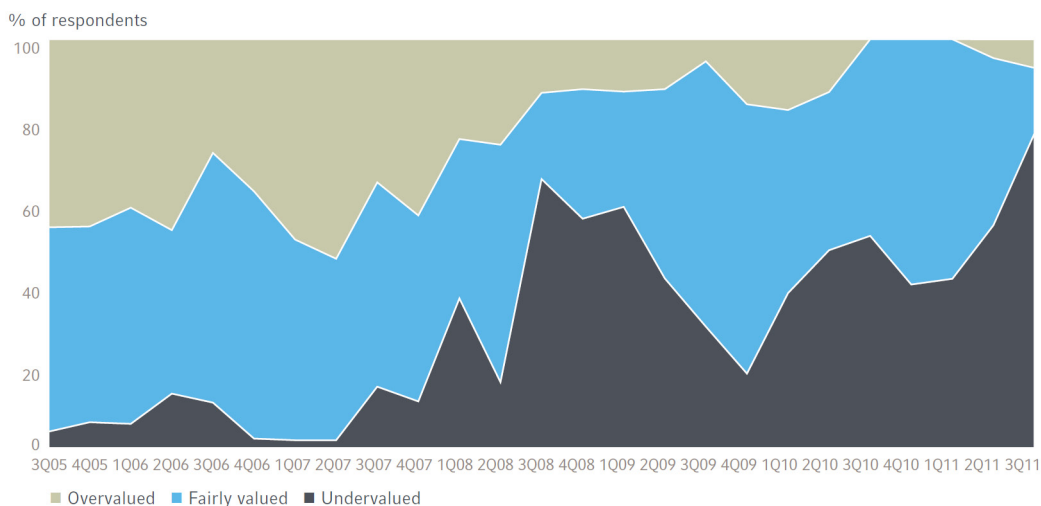
Which of these general valuation conditions best describes the current Australian share market?

Key findings:

» The number of managers who view the Australian share market as undervalued has reached its highest point in the history of the survey (September 2005).

» This quarter, an overwhelming majority (77%) believe the local market to be undervalued

Exhibit 4A: Shifts in market valuation



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

“We are positive on Australian equities as the recent sell off has opened up highly attractive valuations while underlying risk within the Australian corporate sector is low.”

Mike Jenneke
Sigma Funds Management



Results

Asset class expectations

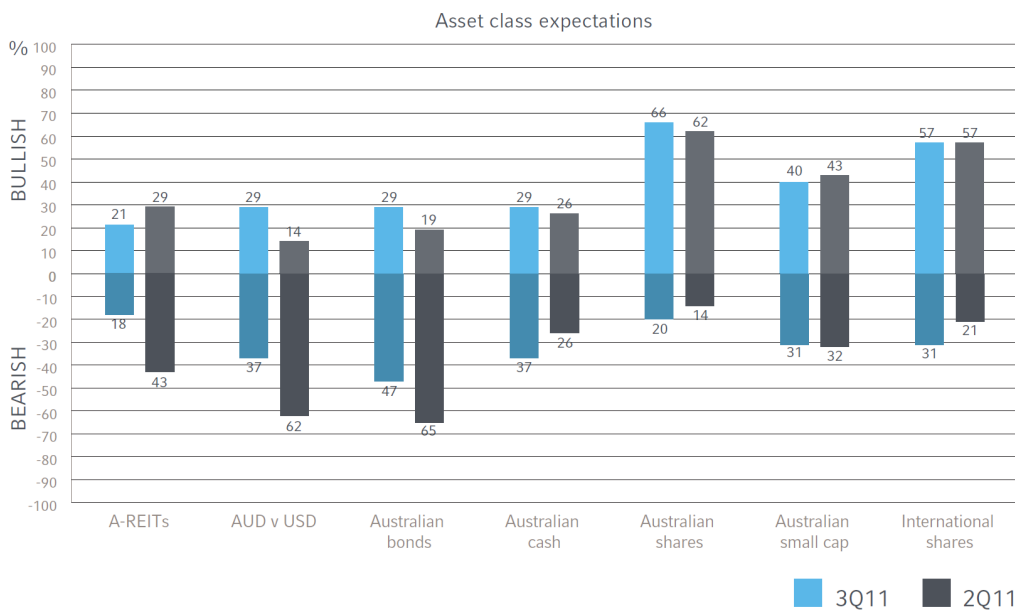
Question 2:

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

Key findings:

- » Managers continue to be most bullish on Australian shares, presumably due to the domestic economy's stability relative to the US. Shares continue to dominate the top three spots this quarter.
- » Increased uncertainty regarding the outlook for global growth saw bullish sentiment toward Australian bonds rise from 19% to 29%.

Exhibit 5A: Manager expectations – asset classes



“Uncertainty about the global economic outlook has exceeded the market’s appetite for risk and so the share market is trading on swings in sentiment. The market is now priced for all but the most dire of outlooks and represents good long-term value.”

Andrew Sisson
Balanced Equity Management



Results

Sector expectations

Question 3:

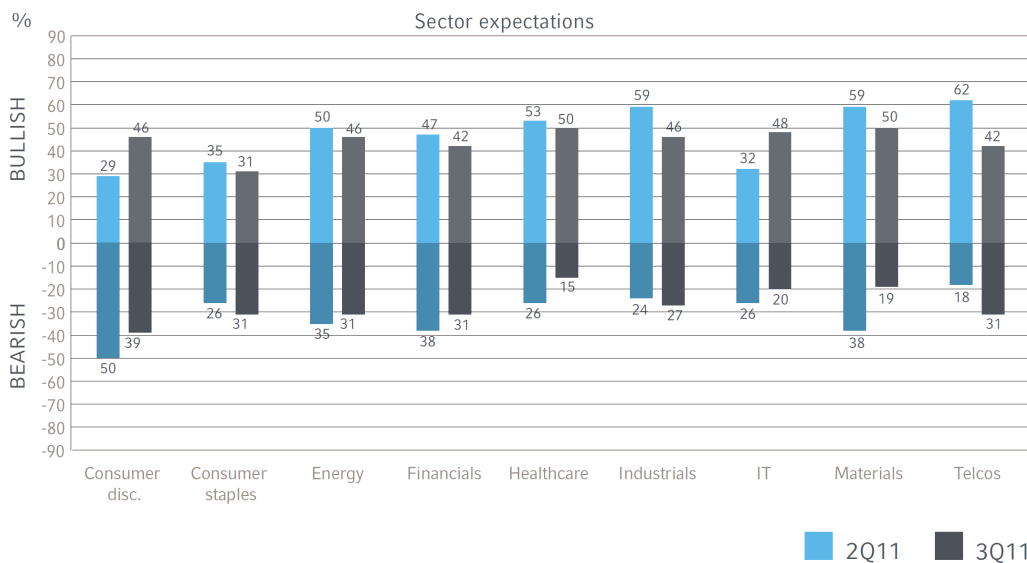
What are your expectations for the performance of the following sectors over the next 12 months?

Key findings:

» Bearish sentiment toward the materials sector doubled from 19% to 38% over the quarter as uncertainty regarding the outlook for global growth and the threat of further monetary tightening in China continued to play on managers’ minds.

» The outlook for industrials improved significantly throughout the quarter, with 59% of all managers surveyed seeing value in the sector. This was up from 46% last quarter.

Exhibit 5B: Manager expectations – Australian sectors



“The banking sector overall has been impacted by offshore events including continued sovereign debt concerns and hampered by softer domestic trends.”

Wes Campbell
JCP Investment Partners



Results

Two speed Australian economy - triggers for recovery?

Question 4:

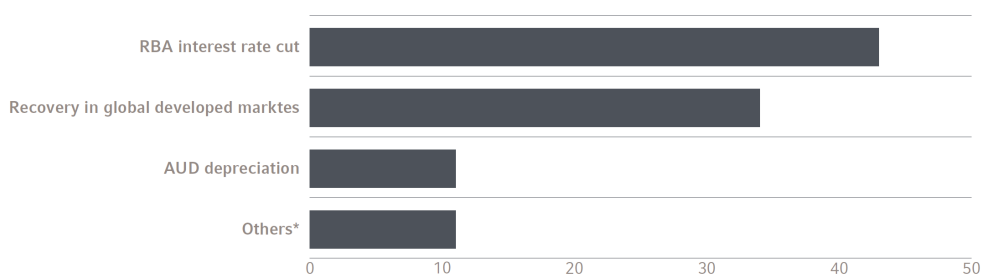
The two-speed Australian economy persists with the outlook for resources and industrials continuing to diverge. In your opinion, what is the most likely factor/trigger for recovery in domestic growth in the non-resources sectors?

Key findings:

» The majority of managers (43%) believe lower interest rates will be the main catalyst for a recovery.

» Another potential trigger for igniting Australia's non-mining sectors is a recovery in global developed markets, with 34% of managers surveyed believing that improved stability globally¹ would provide struggling domestic sectors with a significant boost in the form of greater consumer and business confidence.

Exhibit 6A: Triggers for recovery in domestic growth for the non-mining sectors %



¹ This quarter's US Investment Manager Outlook asked managers whether the US economy is entering a double-dip recession. A summary of the survey results can be in the Appendix overleaf.

“The two-speed Australian economy remains evident... The recent company reporting season saw results broadly in line with expectations. Higher sales growth was offset by weaker margins as a consequence of increased costs and the impact of a strong AUD.”

Lee Mickelborough
Perennial Growth Management



APPENDIX

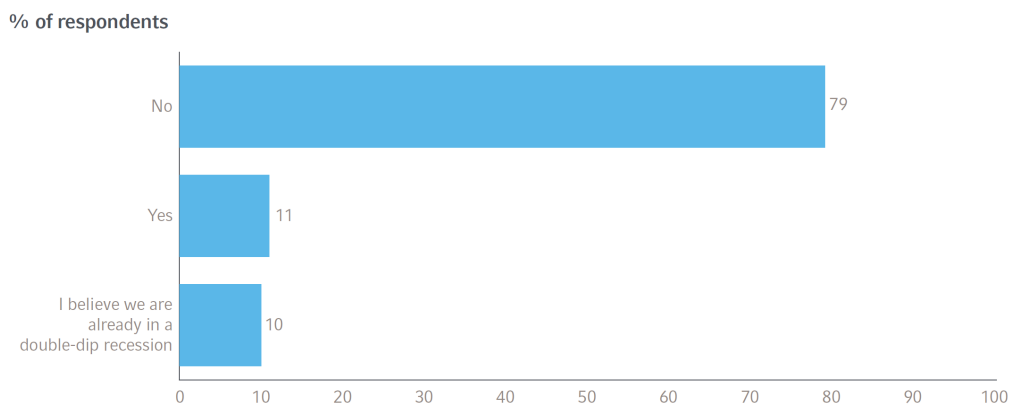
Highlights from Russell's US IMO survey Q3 2011

Russell Investments also survey US investment managers on their market insights. In particular, this quarter's US Investment Manager Outlook asked managers whether the US economy is entering a double-dip recession. Highlights of the survey findings are summarised below.

Summary of Key Findings

The majority of managers surveyed say they do not believe the United States is entering a double-dip recession.

Exhibit 7A: Do you believe the U.S. economy is entering a double-dip recession?



Key findings:

» A significant majority, 79 percent of managers, say they do not believe the United States is entering a double-dip recession. Most cited strong corporate balance sheets and high corporate profit levels as the main reason for their belief. Despite this optimism, 62 percent of those managers who rejected the double-dip recession theory do believe U.S. economic growth will remain slow for the next several years. Other economic indicators frequently cited by managers as support for their opinions that the United States will avoid a double-dip recession include the U.S. Federal Reserve's long-term, low interest-rate policy, declining oil prices and U.S. dollar weakness. Exhibit 7B contains more details.

» On the other hand, 11 percent of managers believe the United States is entering a double-dip recession and another 10 percent believe the country has already entered a double-dip recession. Of those managers, 95 percent cited a jobs recovery as the critical element required to help the country recover. The next most cited elements by these managers are improving consumer confidence and consumer consumption, resolution of political/policy issues with respect to U.S. debt, successful resolution of the European debt crisis and a U.S. housing market recovery. Exhibit 7C sets out more details.

“79 percent of managers, say they do not believe the United States is entering a double-dip recession”

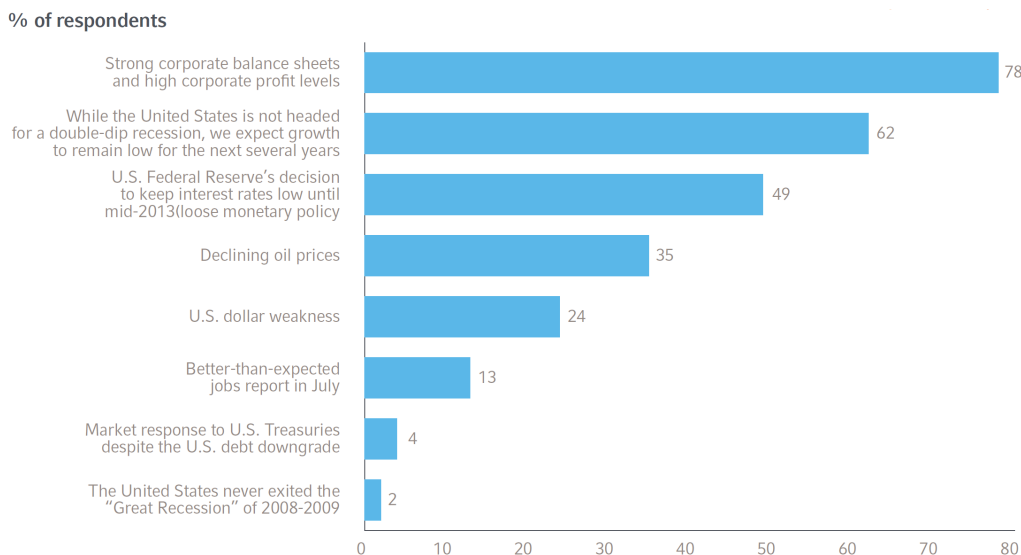


APPENDIX

Highlights from Russell's US IMO survey Q3 2011 (continued)

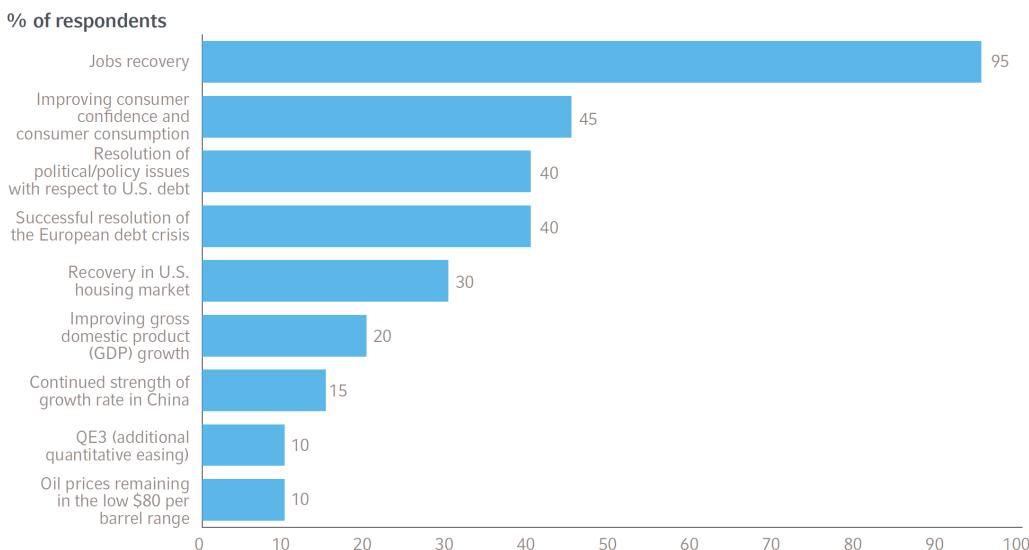
» Of particular note to Russell is the significant divergence in viewpoint between professional money managers, as evidenced by survey responses, and individual investors. The majority of professional money managers are not reading market volatility as a warning sign of an impending economic meltdown. Instead, many are treating volatility as a buying opportunity. Russell believes the nervousness and extreme risk aversion displayed by average investors is an emotional response to ongoing market volatility, rather than a rational response to underlying company fundamentals.

Exhibit 7B: (IF NO...) What economic indicators do you feel support that the United States is not headed into a double-dip recession? (Please choose top three priorities)



"The majority of professional money managers are not reading market volatility as a warning sign of an impending economic meltdown"

Exhibit 7C: (IF YES/ALREADY IN...) What will it take to avoid/lead the United States out of a double-dip recession? (Please choose top three priorities)?





Methodology and about Russell Investments

Methodology

Russell Investments conducted the Australian Investment Manager Outlook between 5 to 16 September¹.

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, 35 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.

Everything we do is guided by our desire to improve financial security for people. For more information about how we help investors around the world achieve their goals, visit us at www.russell.com.au.

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.

¹ The US Investment Manager Outlook, summarised in the Appendix, was conducted between August 23 and September 2, 2011.



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-REITs on the Australian Stock Exchange, primarily run by property management groups such as Lend Lease, Westfield and Deutsche Asset Management. A-REITs 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 Russell Developed Large Cap – Net 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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