

The View

A quarterly publication from QIC - April 2010

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Message from Doug



Welcome to the first edition of The View for 2010. As I write this article, the outlook for the global economy certainly looks different compared to 12 months ago. In the first half of 2009, we were still well

in the midst of the global financial crisis (GFC), with most developed economies in recession and governments and regulators around the world taking extraordinary actions as they tried to restore stability and liquidity to the global financial system.

Now, recovery in the global economy is well underway and the significant support provided by governments and central banks is gradually being withdrawn. The US has now posted two positive growth quarters in a row, with household consumption contributing positively in both. The outlook for Australia is looking particularly positive, with private investment continuing to recover and the government ramping up its investment program. Recent data shows that our gross domestic product (GDP) grew by 0.9 per cent in the December quarter to be 2.7 per cent higher through the year, which is an extremely positive result considering that most advanced economies contracted in 2009.

However, employment is still a big risk, both globally and in Australia. Households won't spend on discretionary consumer goods if they feel their future income is at risk, and the labour market must stabilise sufficiently for consumer confidence to return. While there are indications that bankruptcy rates are peaking and the number of hours worked are normalising (i.e. increasing), and

while business confidence continues to rise, all of these variables must return to normal before employment growth returns.

While the global economy is looking much more positive, one potential storm on the horizon is centring around Greece. The behaviour whereby US financial institutions overleveraged and concealed their true debt levels by clever financial engineering was apparently copied by some sovereign entities. In particular, the 'PIIGS' economies (Portugal, Ireland, Italy, Greece and Spain) now find themselves in difficult positions, potentially defaulting on their sovereign debt. While sovereign defaults are more common than most people think, they do cause problems for markets. So, apart from having to radically restructure their taxation and spending patterns, the PIIGS are looking to other Euro economies for financial support to avoid such an outcome. In my view, this problem will be confined to the Euro area because of the political imperative to hold the euro currency together. Then again, back in 2007 I thought the sub-prime crisis would be contained because, on face value, it was a small part of the total US debt markets. Only time will tell.

Inflation also remains a concern. In 2008, global inflation was exported from emerging market economies as they faced skills shortages and capacity constraints. Now, notwithstanding the recent big deflationary shock and current output gap issues, headline inflation is rising in emerging markets and around the world. On page 3, Susan Buckley, Managing Director, QIC Global Fixed Interest, discusses some of the strategies funds can employ to protect their portfolio from rising inflation.

QIC's transformation is now complete

The outlook for the global economy has changed significantly in the last 12 months, and so too has QIC. In 2009, we announced a new corporate strategy and changed from a branded house to a 'house of boutiques' business model.

We also have a new organisational structure and a new Executive Leadership team. Hazel McNeilage has commenced in her role as QIC's new Head of Funds Management and has been travelling around the country meeting with clients and their asset consultants. You can find out more about Hazel on page 2.

With our new structure now firmly in place, our ten investment boutiques are focused on delivering client outcomes and leveraging the opportunities in the current environment for the benefit of our clients. One of the opportunities QIC recently committed to is in the area of lifecycle funds, which are currently not available to most Australian superannuation fund members. To lead this initiative, we have appointed Professor Michael E Drew, a highly regarded researcher on the provision of retirement incomes. Watch this space for more information about this initiative in the coming months.

I hope you enjoy this latest edition of the View. As usual, if you have any feedback, questions or challenges for me or the QIC team, please send them to me directly at d.mctaggart@qic.com.

Doug McTaggart
Chief Executive

Introducing Hazel McNeilage

Find out more about QIC's new Head of Funds Management in this short Q&A.

What was your role before joining QIC?

Prior to joining QIC, I was part of the senior management team at Principal Global Investors, a US-based global asset manager with around US\$215 billion in assets. During the eight years I was there I had a variety of roles, including managing the firm's Asian business (based in Singapore), overseeing the investment teams of seven affiliates and joint ventures across Asia and Latin America, and global responsibility for all client-facing and sales activities (based in New York).

Why did you choose to join QIC?

There are several reasons. I wanted a role where I could combine responsibility for investment teams with oversight of client-facing activities, which is what the Head of Funds Management role at QIC involves. I wanted to work in a multi-boutique organisation because, having experienced a range of asset management structures, I believe that this is a strong model when well implemented. I wanted to work with really smart people, which QIC definitely has. Finally, from a personal point of view, I was keen to live and work in Australia again. So, QIC is a great fit for what I was looking for. Four months into the role, I am really pleased that I made the decision to join QIC.

When did you last work in Australia?

From 1987 to 2003. I moved to Australia in early 1987, just when the move from defined benefit (DB) to defined contribution (DC) was really starting to take off. I joined Towers Perrin and my first major assignment was the conversion of the superannuation plan of one of Australia's big four banks from DB to DC. In 1994, I took over responsibility for Towers Perrin's asset consulting business for Australia and Asia Pacific. As part of that role, I had the opportunity to work with many of Australia's largest funds, and it is great to see that several of the people I worked with then are still active in the industry.

And before Australia?

Six years in the early 1980s with a large financial institution in Johannesburg, South Africa – a tough place to live at that time, but given the enormous skills shortage, great experience from a career perspective. Originally I am from the UK, which is where I grew up, was educated and did my first job (an actuarial role with a small financial institution).

On first observation, what are some of the current challenges and opportunities for the Australian superannuation industry?

The Australian superannuation industry is pretty sophisticated by global standards.

Superannuation funds here are typically better diversified both by asset class and geography than pension funds in a variety of other countries. A key challenge is adequacy – a 9% contribution is simply not enough to generate sufficient assets for a comfortable retirement. Another challenge is designing products that are effective in transitioning people through their working career, into retirement and then through retirement. I think that well-designed life cycle funds can play a really important role in this, and there is a great opportunity here to enhance the Australian system.

What will be your focus for the next 12 months?

Making sure that QIC continues to deliver strong investment performance for our clients is my number one priority. Delivering strong investment performance is all about people – making sure we have the right people in the right roles with the right support and the right motivation and alignment of interest with our clients. I also want to make sure that QIC has the kind of relationships with our clients, and more generally with major institutions and consultants, such that they will look to QIC to help them meet their investment goals.



Hazel McNeilage
Head of Funds Management

Financial market snapshot

Key Market Indicators (as at 31 March 2010)	FYTD	1 Year	3 Year	5 Year	10 Year
Australian Shares	27.3%	41.7%	-2.4%	8.1%	8.9%
International Shares (Unhedged)	11.5%	17.0%	-9.4%	-0.7%	-4.3%
International Shares (Hedged)	27.9%	50.5%	-5.3%	3.7%	0.4%
Australian Bonds	4.1%	2.7%	6.5%	6.0%	6.3%
International Bonds (Unhedged)	-9.2%	-19.2%	2.1%	1.0%	1.6%
International Bonds (Hedged)	5.6%	5.7%	8.1%	7.1%	7.7%
Direct Property (Australia)	3.2%	-3.0%	0.6%	6.3%	8.4%
Listed Property (Australia)	22.0%	40.6%	-22.8%	-6.9%	3.7%
Inflation (CPI)	-	2.1%	2.9%	3.0%	3.2%

Protecting your fund against inflation

In the last edition of *The View*, Matthew Peter, QIC's Chief Economist, talked about the current risks to inflation. In this edition, Susan Buckley, Managing Director, QIC Global Fixed Interest, discusses how funds can prepare themselves for a potentially higher inflationary environment.

During the global financial crisis, policy-makers around the world enacted an unprecedented level of monetary and fiscal stimulus in an attempt to 'pump-prime' their economies. Now, as global economies recover, there are concerns about the impact these policy initiatives will have on inflation.

QIC Global Fixed Interest (QIC GFI) does not believe inflation is an immediate concern for three key reasons:

- Recent data indicates that there is still significant excess productive capacity in the global economy. This should limit inflation in the short term.
- Global central banks are very conscious of containing inflationary expectations. If these start to get too high as a result of current programs, central banks will start to unwind these programs to ensure their credibility.
- History shows that inflation outcomes tend not to be a problem following a recession, particularly for financially induced and balance sheet recessions (such as the recession we have just experienced).

However, we believe it is a significant risk in the medium term (i.e. three to five years). The main risk is that policy-makers will mistime their exit strategies or will succumb to political pressure to maintain easy monetary policy while the unemployment rate remains high. This could lead to unwanted inflation.

Protecting your fund against inflation

There are a number of approaches to inflation protection, but not all are particularly effective.

Traditionally, equities have been regarded as an effective hedge against inflation. However, our research has shown that traditional assets such as bonds, equities and property can in fact be negatively correlated with inflation, thereby providing little protection against inflation.

Instead, allocations to inflation-linked securities (e.g. inflation-linked bonds) provide the best and purest protection against inflation spikes. However, they do involve a number of risk factors, including inflation, interest rate, credit and issuance risks. A physical exposure also requires an equivalent amount of cash to be invested in the underlying security. As such, the only way to increase the exposure is by increasing the capital allocation or buying longer-dated securities. This increases both the interest rate risk and inflation exposure of the portfolio.

To address these issues, the use of derivatives can provide a more flexible and tailored solution to meet the needs of investors. Specifically, inflation risk can be hedged through the use of derivatives called 'inflation swaps'. These over-the-counter (OTC) securities are customised securities that provide the flexibility to allow particular exposures to be hedged more effectively.

Taking a global approach

Another main drawback to inflation protection via inflation-linked bonds has been the lack of supply.

In September 2009, the Australian government recommenced its issuance of inflation-linked bonds (known as Treasury Indexed Bonds or TIBs) following a six-year break. State governments have also recently recommenced issuing CPI bonds. The Australian government is expected to significantly increase its issuance of TIBs and we expect there will be further improvement to liquidity in the Australian inflation market.

However, the Australian inflation market is still small and can be illiquid. When the Australian market does present liquidity constraints, QIC GFI recommends taking a global approach to inflation protection.

Globalisation has caused inflation to become highly correlated between economies. Where Australian inflation is unavailable or is expensive relative to other countries, a relative-value process, such as that used by QIC GFI, is an effective way of identifying correlated sources of inflation protection.

Is your fund prepared?

While we do not believe inflation is an immediate concern, there is no doubt that it is a significant risk that investors should not ignore.

In their recent paper *'What matters in global markets: The outlook for developed world inflation'*, the Watson Wyatt Global Investment Committee said inflation "is a key certainty facing investors over the next years".

Our research, which is outlined in the Red Paper *'The risk of rising inflation'*, confirms this view, showing the significant impact that policy decisions could have on inflation outcomes over the next five years.

At current prices, funds can access relatively 'cheap' insurance against inflation. However, funds should act quickly as the cost of this protection is likely to rise.



Susan Buckley
Managing Director,
QIC Global Fixed Interest

QIC Forecast	Australia			US			Europe		
	Current	Jun-10	Dec-10	Current	Jun-10	Dec-10	Current	Jun-10	Dec-10
Interest rates	4.25%	4.50%	5.00%	0-0.25%	0-0.25%	0.75%	1.00%	1.00%	1.00%
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Economic growth	1.3%	3.3%	3.9%	-2.4%	3.3%	2.7%	-4.0%	1.2%	1.6%

Economic and market snapshot

After a shaky start to the year, financial markets stabilised in mid-February following an announcement by the European Union (EU) heads of state and government in support of the Greek government's efforts to restore the health of its public finances. Having fallen by around 5 per cent to that point since the start of the year, global equity markets (as measured by the MSCI World Index, local currency) rallied by 9.3 per cent to the end of March, to be around 6 per cent higher over the calendar year. Concerns about the fiscal outlook in Greece weighed on European markets, with European equity prices underperforming the global average and the euro falling by 5.5 per cent against the US dollar in the last three months.

Structural issues related to public finances and labour markets mean that the Euro area economic recovery will be weaker than the recovery in the Asian and North American regions. We expect Euro area real gross domestic product (GDP) growth to average only 1.2 per cent in 2010 and

1.6 per cent in 2011. Weak economic growth will ensure that Euro area inflation is subdued, and we expect the Euro area inflation rates to average 1.5 per cent in 2010-11. Low growth and inflation will see the European Central Bank keep rates on hold until the end of 2011.

In contrast, we expect the US economy to grow at an above-trend rate of 3.3 per cent in 2010, before slipping back to a more trend-like rate of 2.7 per cent in 2011. US inflation should average around 2 per cent over 2010-11 as downward pressure from low unit labour costs is partially offset by high rates of import price inflation. As evidence of a sustainable recovery in the US economy mounts, the US Federal Reserve (Fed) will tighten monetary policy. Most likely, the Fed will begin with reverse repurchase agreements to reduce bank excess reserves on the Fed's balance sheet, followed closely by increases in the federal funds rate and the interest rate on banks' excess reserves (IOER) held with the Fed. We anticipate

the Fed will tighten the federal funds rate and the IOER rate simultaneously in the second half of the year, most likely at the September meeting.

The Australian economy will continue to benefit from its links with the Asian region, which is leading the global economic recovery. The economies of China, Thailand, Taiwan, Malaysia, and Hong Kong all posted quarterly real GDP growth rates in excess of 2 per cent for the December quarter, while Japan grew close to 1 per cent. The prospects for the Australian economy will continue to improve, supported by recovering investment expenditure. The first estimate of 2010-11 Australian private capital expenditure intentions suggests nominal investment growth of around 20 per cent as the construction of large-scale mining projects commences. Given firm growth prospects, we expect the Reserve Bank of Australia will continue to lift rates to 5 per cent by the end of 2010.

QIC Global Real Estate attracts \$500 million investment from AustralianSuper

AustralianSuper, one of the largest superannuation funds in Australia, has invested \$500 million in QIC Global Real Estate's QIC Property Fund (QPF), making it a cornerstone investor in the fund.

Head of QIC Global Real Estate, Robert Carter, welcomed AustralianSuper's investment in QPF.

"There is a strong alignment between AustralianSuper's investment objectives and QPF's long-term growth strategy," Mr Carter said.

"The assets in QPF have predictable income streams and significant potential for further growth. Importantly, AustralianSuper is highly compatible with QPF's existing investors," he said.

The QPF \$5.1 billion* portfolio focuses on major regional shopping centres in population growth corridors, with assets including Castle Towers shopping centre in Sydney's north-western suburbs, Robina Town Centre on the Gold Coast, Watergardens in Melbourne's western suburbs and the Canberra Centre in the ACT. QPF also has a tactical exposure to

major capital city CBD office markets.

Mr Carter said the key to QPF's success was a combination of people and property.

"QIC Global Real Estate (QIC GRE) has a track record of delivering stable returns from its portfolio of properties since the commencement of real estate investment activities in 1989," he said.

"QPF's success is due to the quality and stability of the QIC GRE's 170-person management team and its focus on actively managing premium property with proven leasing track records."

* As at 31 March 2010



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