Dynamic Investment Solutions

QIC

The View

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In this edition

Message from Doug

Welcome to the first edition of The View for 2011. It has been an extraordinary start to the year for many of us, as we have witnessed nature's destructive force in almost every corner of the country, nowhere more than in Queensland. Brisbane's CBD was evacuated during January's floods and QIC's head office remained inaccessible for almost two weeks. Thankfully, our staff and their families remained safe and I was pleased that, despite facing a crisis that was both significant and unprecedented, QIC's business continuity plan enabled us to continue managing client portfolios with minimal disruption. This is testament to our preparation, our strong processes and the calibre and dedication of our people.

The full economic impact is just starting to emerge as authorities and communities begin the massive task of rebuilding. The damage sustained by critical primary industries, combined with disruption to economic activity in a region where tourism is a major employer, suggests our economy's short-term growth prospects will be severely hampered this quarter. Early indications, however, are that the impact in the medium term will be negligible, and there is little evidence that the cost of reconstruction will have a significant impact on GDP growth rates over coming years. You can read more about the economic effect of the floods on page 4.

Turning our attention to the global economy, it is recovering more strongly than most commentators anticipated. As I said in the February 2009 edition of The View, the Great Recession (as we now call it) was caused by consumers, globally, withholding discretionary spending as they waited to see how their economic environment would be affected by unfolding events under a torrent of constantly bad news. As they all did this at the same time, we suffered what Keynes called the 'paradox of thrift'. Ironically, as the economic environment rapidly deteriorated due to the mass strike by consumers, they each felt vindicated for their prudence when the global economy entered into recession.

As consumers' individual circumstances became clearer, however, those still in employment – 90 per cent of workers in the US, for example – began cautiously restoring previous levels of spending. Consequently, consumption spending in the US has returned to normal levels of about 3 per cent growth per year. The multiplier effects of resuming spending spill over into increased investment, and ultimately, increased employment.

Many commentators remain pessimistic about the sustainability of the recovery. They point to the depth of the fall from the previous peak output and worry that employment growth isn't sufficient to maintain momentum. However, trajectories from previous recessions that compare the rate of growth in output and employment from the trough of the recession to recovery show us that this recovery is at least as strong as any before.

Typically in previous recessions, employment growth has been lagging – the so-called 'jobless recoveries'. This time is no different, but I think employment growth in the US is about to accelerate. Firstly, the number of average hours worked per worker has greatly increased as existing workers work longer, but there is a limit to this, which we are now seeing. Additionally, the rate of growth in bankruptcies has slowed to the point where the number of newly unemployed will be less than the increase in new workers. Total employment will grow strongly, as will consumption. This will provide the necessary impetus for other economies globally.

Attention will now turn to residual issues ensuing from the policy solutions enacted to mitigate the recession – that is, how to deal with the massive build-up of sovereign debt and liquidity, the results of expansionary fiscal and monetary policies.

Australia will also benefit from a strong US economy, but we have our own set of challenges. Apart from the temporary disturbances caused by this summer's extreme weather, we face the prospect of returning to the 'two-speed economy' we last saw in the years leading up to 2008. This is caused by the strength of the Australian currency on global foreign exchange markets, driven by high commodity prices and strong earnings of foreign income due to the commodity boom (mark II). The resource-rich states do well at the expense of the other states. There has been some talk of creating an Australian sovereign wealth fund, funded by the benefits of the resources boom. If this wealth was invested offshore during

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the boom, so that capital outflows roughly equalled capital inflows, then the exchange rate effects would be mitigated and the source of the two-speed economy would be removed. However, since this solution is unlikely to be adopted, the only recourse for those export industries suffering from the high exchange rate is to improve productivity growth. This is a national problem and one that's high on the agenda of the Council of Australian Governments and the business community.

Nonetheless, I continue to remain positive about the economy and very optimistic about the future of QIC. Our investment boutiques finished 2010 strongly. In November, QIC's Global Infrastructure (GI) boutique was part of the Q Port Holdings consortium that successfully bid for the 99-year lease of the Port of Brisbane. The Port is an essential piece of infrastructure for South East Queensland, and provides our clients with a high-quality asset and robust and diversified trade exposure. QIC GI also welcomed the opportunity to acquire Queensland Motorways Limited, owner of the Gateway and Logan Motorways, from the Queensland Government. These motorways play a vital role in the future growth of South East Queensland. QIC GI now boasts a A$3 billion global investment portfolio of 14 unlisted infrastructure assets including investments in Brisbane Airport, the Westlink M7 toll road in Sydney, Thames Water, and Grup Maritim TCB, a global ports developer.

Global Fixed Interest's GFI Alpha Fund has received its first offshore client, with Paris-based Lyxor Asset Management investing in a replication of the fund on its own platform. You can read more on page 3.

QIC Global Real Estate celebrated the latest phase of its landmark expansion program at Robina Town Centre, which was named Retail Property of the Year for the second consecutive year at the Queensland Property Council of Australia Awards, further cementing its position as the leading retail centre in the region.

Our strong investment performance across a wide range of asset classes is very pleasing, particularly given challenging markets. Our multi-boutique structure supports the focus of our investment professionals on delivering strong performance, and today, QIC serves over 80 clients - including 11 of Australia's largest 25 super funds. While we are not a manager that seeks growth for growth's sake, it is gratifying that a growing number of large institutions choose to invest with us.

Last month we made a number of key appointments: David Addis, Managing Director, Corporate Strategy, Claire Blake, Chief Financial Officer and Willie Jordaan, Chief Operating Officer join QIC's executive leadership team. You can read more on page 3.

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

Doug McTaggart
Chief Executive

QIC stays buoyant in Brisbane floods

As it swiftly became apparent on 11 January that Brisbane was not going to escape the flood waters that had already inundated much of Queensland, QIC was one of the first organisations in the CBD to invoke its business continuity plan. By lunchtime, all Brisbane staff had been evacuated from the city and preparations were in full swing to activate two dedicated disaster recovery sites and remote networks. This protected the safety of QIC personnel while also providing secure systems to allow key staff to manage client portfolios and attend to business critical matters with minimal disruption.

As the crisis in South East Queensland escalated and flood waters reached the basement of our head office on Eagle Street, QIC staff continued to operate business critical functions from our disaster recovery sites, from secure networks at home and from QIC's offices in Sydney and Melbourne. Staff who were not identified as business critical were encouraged to contribute to the clean-up effort in their local communities until our Brisbane office reopened on 24 January.

Michelle Smith/Fairfax Photos

Fortunately, QIC's assets escaped relatively unscathed. Grand Central and Garden Town shopping centres in Toowoomba experienced only minor damage and all stores in these centres have since reopened. Brisbane Airport infrastructure was undamaged and the airport continued to operate as normal. The Port of Brisbane closed on 11 January for safety reasons, but reopened on 21 January after hydrographic surveying and dredging teams identified and removed debris. Importantly, the port infrastructure was not damaged.

Our thoughts remain with those in cyclone and flood-affected areas and those involved in the process of rebuilding their homes and communities. QIC has donated $100,000 to the Premier's Disaster Relief Appeal, and encouraged staff to donate by matching each dollar pledged, raising a further $20,000.

QIC bolsters executive leadership team

Last month we welcomed three new faces to the QIC executive leadership team. David Addis has joined as Managing Director, Corporate Strategy, after Michael Pennisi departed last year. David will be responsible for further developing QIC's strategic vision. David is a welcome addition to the QIC team with a background in investment banking and fund management, and experience with Investec Bank, Macquarie Bank, Wilson HTM and Rothschild Australia.

Following the recent departure of Chief Financial and Operating Officer, Robert Hines, we have decided to split the role responsible for our Finance and Operations teams, and welcome Claire Blake to the position of Chief Financial Officer, and Willie Jordaan to the position of Chief Operating Officer.

Claire has worked at QIC for almost 20 years and has been integral in building QIC's solid financial platform, most recently as Group Financial Controller. Willie joined QIC last year and successfully led the delivery of the Sophis Value risk management system. Willie has extensive industry experience in business operations and was previously a partner at PricewaterhouseCoopers.

David, Claire and Willie join Doug McTaggart, Chief Executive, Hazel McNeilage, Head of Funds Management, Paul Leitch, Managing Director, Human Resources and David Clarke, Managing Director, Organisational Risk and Legal on QIC's executive leadership team.

Another important appointment is Cliff Smith, who joins QIC as Managing Director, Institutional Business and is based in our Melbourne office. Cliff has over 20 years' experience in the Australian institutional market including business development roles with Perennial Investment Partners and Merrill Lynch Investment Managers. Reporting to Head of Funds Management, Hazel McNeilage, Cliff will work closely with major institutional investors and their consultants to ensure that QIC understands and responds to their needs in a seamless way. His role complements the investment specialists within QIC's boutiques.

GFI takes steps into Europe

QIC's Global Fixed Interest (GFI) boutique has welcomed Paris-based Lyxor Asset Management as its first European client. Lyxor has invested in a replication of the GFI Alpha Fund on its own platform, which also hosts 100 other world-leading alternatives managers. The GFI Alpha Fund is a combination of global interest rate and credit strategies actively managed to increase returns and minimise risk. It has built a strong track record of performance since its inception in 2005.

Lyxor responded to GFI's global marketing efforts and began a detailed review of GFI's investment team and processes, including risk management and operational support, in mid 2010. The successful due diligence process resulted in a positive recommendation to Lyxor clients globally, and the fund was transitioned to Lyxor's platform early this year. Having GFI staff in London assisted in the smooth transition of this significant new account.

GFI's various alpha vehicles now have more than $500m in funds under management, with eight new institutional clients this financial year and consistently strong support from a range of key asset consultants.

Financial market snapshot

Key Market Indicators (as at 31 January 2011)	*FYTD*	*1 Year*	*3 Year*	*5 Year*	*10 Year*
Australian Shares	13.0%	8.5%	-1.3%	3.6%	8.0%
International Shares (Unhedged)	6.8%	6.6%	-5.0%	-3.5%	-3.7%
International Shares (Hedged)	23.0%	20.5%	-0.4%	1.9%	2.4%
Australian Bonds	2.0%	5.6%	7.3%	5.9%	5.8%
International Bonds (Unhedged)	-9.7%	-5.9%	0.8%	0.8%	0.3%
International Bonds (Hedged)	2.2%	7.1%	7.5%	7.1%	7.4%
Direct Property (Australia)	6.3%	11.1%	-1.3%	5.9%	8.3%
Listed Property (Australia)	5.0%	5.0%	-16.2%	-8.8%	2.7%
Inflation (CPI)	-	2.7%	2.8%	2.9%	2.9%

Strong response to Inflation Plus Fund

In the last edition of The View, Global Fixed Interest (GFI) had recently launched its Inflation Plus Fund, which takes a dynamic approach to protecting a fund from the potentially damaging effects of high inflation. Since its launch in September, the fund has delivered on the CPI plus 4 per cent investment objective, by actively managing exposures to interest rates and inflation to suit the prevailing risk environment. By using this approach, the fund has exceeded investment objectives with significantly less volatility than traditional inflation protection strategies.

GFI's Senior Portfolio Manager, Inflation, Kent Wilkes, said 'When interest rates rose in October, and markets priced in the risk of higher inflation, the fund benefited by increasing exposure to inflation while initially reducing interest rate exposure. As the pricing of inflation expectations approached GFI's 'fair value' and interest rates rose to more attractive levels, we reduced the inflation position and added interest rate exposure at higher yield levels.'

By choosing an approach in which portfolio positions are continually refined to take advantage of opportunities as they arise, investors can have greater confidence that their inflation protection strategies will meet their investment objectives.

For more information about the QIC GFI Inflation Plus Fund, please talk to your QIC investment specialist or the GFI team on 61 7 3360 3942 (gfi@qic.com).

Floods dampen GDP growth in the short term

'The flooding that affected the eastern states of Australia earlier this year looks destined to puncture the short-term growth prospects of the economy, and temporarily increase the rate of inflation. The impact in the medium term, however, will be minimal and indications are that GDP growth will not be significantly affected beyond 2011.' This is the outlook from QIC's Economics & Research team in response to this summer's extreme weather conditions.

Our estimates show a sharp reduction of 0.6 per cent in real gross domestic product (GDP) growth in the current quarter when we incorporate the impact of the floods. This will represent the first quarter of negative GDP growth since 2008 quarter 4 at the height of the global financial crisis. Half of the decline in growth this quarter is due to the disruption to economic activity in Brisbane, while a loss of coal production contributes around a third of the fall in growth. Disruption to agricultural production – worsened by the effects of tropical cyclone Yasi - is expected to lead to a temporary spike in food prices, pushing inflation up to around 3.5 per cent in mid 2011. The price of bananas has been the most significantly affected due to 75 per cent of the crop being destroyed. The price increase has been tempered, however, by the Queensland Government allowing bananas that have fallen to the ground to be sold, resulting in an increase of just $3 per kilo. As agricultural production recovers to pre-flood levels, food prices are expected to ease, with inflation returning to the Reserve Bank of Australia's (RBA) target band of 2.0 per cent to 3.0 per cent in 2012.

Our analysis indicates GDP will largely recover to its baseline level in the second quarter of 2011. Nonetheless, output lost in the first quarter is sufficient to substantially lower the average annual growth rate in 2011 by 0.4 percentage points. Looking further ahead, our results find little evidence that reconstruction will have a significant impact on GDP growth rates over coming years. This reflects two factors: (i) the fully funded nature of the reconstruction of public sector infrastructure and (ii) the low level of expenditure on reconstruction relative to GDP. With the federal government reducing expenditure and raising taxes to pay for the restitution of public sector infrastructure, the net effect on national GDP from reconstruction is approximately zero.

To read our full flood impact analysis, visit the Knowledge Centre on QIC's website at www.qic.com/market-outlook.