

**Quarterly Outlook** draws on the views and opinions of Australia's leading funds management organisations, as well as the views of the Lonsec Investment Committee. Quarterly Outlook presents tactical positions (overweight, underweight and neutral) towards shares, property, fixed interest and cash, reflecting the latest asset allocation weightings adopted by these organisations.

Market	3 mths	6 mths	12 mths
Australian Shares	-2.7	2.9	16.2
Australian Listed Property	-13.0	-8.5	-8.4
Australian Fixed Interest	0.3	1.7	3.5
Cash	1.7	3.4	6.7
International Shares (\$A)**	-2.2	-4.0	-2.6
- US*	-3.1	-1.2	5.8
- Europe*	-1.5	-3.7	6.0
- Japan*	-8.8	-15.8	-10.2
- Asia*	-0.3	13.7	30.4
\$A vs \$US	-0.1	3.9	11.4

\* Returns are in local currencies

\*\* MSCI World ex Aust Index \$A

Volatility remained a key feature of equity markets throughout the December quarter with increased risk aversion and conflicting economic data releases resulting in erratic daily swings in stock market indices. Most major equity markets ended the quarter down, Australia included. Sub-prime issues continued to weigh on investor sentiment, with local stocks such as Centro Properties Group feeling the contagion effects of the global credit crisis. Centro fell more than 80% after encountering difficulties in re-financing its short-term debt arrangements, triggering a broad-based sell-off in the listed property trust (LPT) sector. Australian bond yields have risen in recent months as inflationary pressures continue to build. In what has been a particularly difficult market over the last six months, cash has been the best performing asset class.

### Global Economy

A slowing US economy and the crisis in global credit markets have undoubtedly increased the risks to the global economic growth outlook. The apparent 'de-coupling' of the world economy, however, suggests that weakness in the US economy may be offset to some degree by rapidly growing Asian economies, China and India in particular. The extent to which these developing economies can themselves withstand a slowdown in the US will be determined largely by the severity of such a downturn.



*All eyes on the US as growth slows*

The chance of recession in the world's largest economy, the **United States**, has increased, with falling house prices, rising fuel costs and the increasing cost of credit expected to slow US consumption. With the world's traditional growth engine, the US consumer, under pressure, economies that are heavily reliant on the US for their export markets (Japan and Europe) are also vulnerable. The US Federal Reserve cut interest rates by 100 basis points (bp) in 2007 to 4.25%, and is expected to ease further in an effort to boost confidence and avoid a sustained slowdown in growth.

Economic growth in **Europe** is beginning to show signs of easing, with deteriorating credit conditions, slowing demand and weaker export growth under a strong Euro. The European Central Bank (ECB) remains on hold, while the Bank of England (BOE) has moved to an easing bias, cutting rates by 25bp to 5.50%. **Japan** continues to struggle, with heightened political uncertainty adding to already weak economic results. Core inflation remains close to zero and, with Japanese exporters also facing a slowing US economy, growth is likely to remain subdued in 2008. Developing Asian economies, especially **China**, remain robust, and are relatively well placed to withstand a slowdown in the US due to large foreign reserves, relatively closed financial systems and solid domestic demand.

### Domestic Economy

Notwithstanding increased risks, the Australian economy remains in reasonably good shape. Strong growth (with GDP above 3.5%), unemployment at 30-year lows, a federal budget that is in surplus, and exposure to rapidly growing Asian economies are supportive of continued

domestic growth. The Australian economy does, however, face risks, with rising inflationary pressures (resulting from skills shortages and capacity constraints), rising interest rates, and drought being key threats to the domestic growth outlook. Furthermore, whilst the local economy may have 'de-coupled' somewhat from that of the US, it is not immune from the global influences of slowing global growth and higher funding costs. For example, major Australian banks have recently moved independently of the Reserve Bank of Australia (RBA), raising their mortgage lending rates in order to cover the higher costs of wholesale funding.

The RBA policy stance is finely balanced between these opposing global and domestic factors; however, the recently released strong retail sales figures may have tilted expectations towards further tightening. Widening interest rate differentials and firm commodity prices should remain supportive of the AUD, however the slowing global economy remains a risk.

**Outlook**

The local equity market is likely to moderate and is not expected to generate returns in the same order as the past few years. The strong local currency, the rising cost of debt and the deteriorating global economic outlook are likely to have a negative impact on Australian company profit margins.

Australian bonds are now offering improving (but still average) value relative to cash, with 3 and 5 year bond yields at 6.90% and 6.72% respectively compared to the official cash rate of 6.75%. High debt levels in many listed property trusts, combined with the increased cost of funding, suggest listed property trusts (LPT's) face further headwinds in 2008.

This quarter Lonsec is responding to the outlook for slowing global growth, particularly in the developed world, by reducing our International Equities weighting back to 'neutral'. Lonsec maintains a 'neutral' position in Australian Equities and 'slightly underweight' and 'underweight' positions respectively in International Fixed Interest and Property (LPT's). In taking a more defensive stance, Lonsec has also opted to increase the Australian Fixed Interest (bonds) weighting to 'neutral' from 'underweight'. Australian bonds are now offering better value relative to Cash and International Fixed Interest (bonds) than they have for some time. With the aforementioned changes and a bias still towards rate hikes in Australia, Lonsec has moved to 'very overweight' Cash.

The outlook for equity, fixed interest and property markets are discussed further inside the relevant sections of the Quarterly Outlook.

**Recommended Asset Allocation Weightings**

**Lonsec Tactical Asset Class Positions - January 2008**

Aust Equity	Neutral
Global Equity	Neutral
Property	Underweight
Aust Bonds	Neutral
Global Bonds	Slight Underweight
Cash	Very Overweight
Alternatives	Neutral

**Secure**

	Benchmark	Ranges	TAA position	+/-
Aust Equity				
Global Equity				
Property				
Aust Bonds	30	20-40	30.0	0.0
Global Bonds	30	20-40	25.0	-5.0
Cash	40	30-50	45.0	5.0
Alternatives				
<b>Total</b>	<b>100</b>		<b>100</b>	<b>0</b>

**Balanced**

	Benchmark	Ranges	TAA position	+/-
Aust Equity	23	15-31	23.0	0.0
Global Equity	20	13-27	20.0	0.0
Property	12	8-16	9.5	-2.5
Aust Bonds	15	10-20	15.0	0.0
Global Bonds	15	10-20	13.0	-2.0
Cash	5	0-10	9.5	4.5
Alternatives	10	5-15	10.0	0.0
<b>Total</b>	<b>100</b>		<b>100</b>	<b>0</b>

**Defensive**

	Benchmark	Ranges	TAA position	+/-
Aust Equity	8	5-11	8.0	0.0
Global Equity	6	4-8	6.0	0.0
Property	6	4-8	4.5	-1.5
Aust Bonds	25	17-33	25.0	0.0
Global Bonds	25	17-33	21.0	-4.0
Cash	20	10-30	25.5	5.5
Alternatives	10	5-15	10.0	0.0
<b>Total</b>	<b>100</b>		<b>100</b>	<b>0</b>

**Growth**

	Benchmark	Ranges	TAA position	+/-
Aust Equity	33	22-44	33.0	0.0
Global Equity	30	20-40	30.0	0.0
Property	12	8-16	9.0	-3.0
Aust Bonds	5	3-7	5.0	0.0
Global Bonds	5	3-7	4.5	-0.5
Cash	5	0-10	8.5	3.5
Alternatives	10	5-15	10.0	0.0
<b>Total</b>	<b>100</b>		<b>100</b>	<b>0</b>

**Conservative**

	Benchmark	Ranges	TAA position	+/-
Aust Equity	15	10-20	15.0	0.0
Global Equity	13	9-17	13.0	0.0
Property	12	8-16	9.0	-3.0
Aust Bonds	20	13-27	20.0	0.0
Global Bonds	20	13-27	17.0	-3.0
Cash	10	0-20	16.0	6.0
Alternatives	10	5-15	10.0	0.0
<b>Total</b>	<b>100</b>		<b>100</b>	<b>0</b>

**High Growth**

	Benchmark	Ranges	TAA position	+/-
Aust Equity	41	27-55	41.0	0.0
Global Equity	39	26-52	39.0	0.0
Property	10	7-13	8.0	-2.0
Aust Bonds				
Global Bonds				
Cash				
Alternatives	10	0-20	12.0	2.0
<b>Total</b>	<b>100</b>		<b>100</b>	<b>0</b>

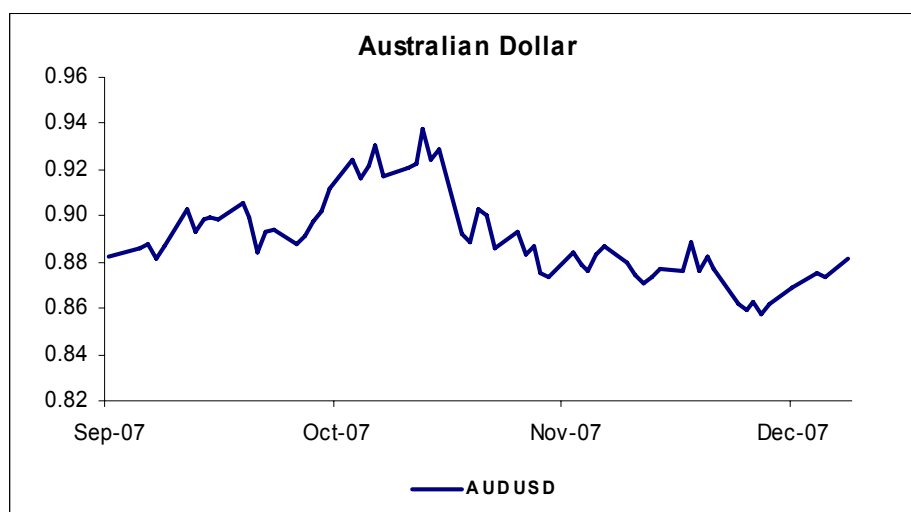
## Sector Overview

Asset Sector	Sector Summary
<b>Cash</b>	With a more defensive stance being taken this quarter, a continuing upward bias for domestic cash rates, and improving but still only moderate apparent value in bonds, Lonsec has moved to 'very overweight' Cash.
<b>Australian Fixed Interest</b>	Lonsec has a moderately improved view of Australian fixed interest, resulting in a shift to a 'neutral' weighting from the previous 'slightly underweight' position. This is reflective of a broader defensive portfolio view and a flattening of the domestic yield curve over recent months as bond yields have risen on inflation concerns.
<b>International Fixed Interest</b>	Lonsec does not consider international fixed interest to currently be attractive, on a relative basis. The recent credit crisis induced 'flight to quality' has pushed down benchmark 10 year bond yields across the major markets of US, UK, Germany and Japan.
<b>Australian Shares</b>	Lonsec retains a 'neutral' allocation to Australian equities. Domestic economic fundamentals remain relatively strong however the local equity market is not immune from US induced credit crisis implications. Further, increasing wages and higher oil prices are expected to place further pressure on inflation.
<b>International Shares</b>	Lonsec has moved to a 'neutral' position in international shares from a 'slightly overweight' position. The risk of a recession in the US has increased over the quarter and growth expectations for the world economy have correspondingly tempered.
<b>Property Trusts</b>	Lonsec maintains an 'underweight' allocation to property trusts. Increased financing costs, the strong Australian dollar and its reversionary implications for currency hedging on foreign income, combined with historically low yields, suggest that capital growth from domestic property portfolios will be limited over the foreseeable future.

## Investment Action

Asset Sector	Recommended Allocation	Preferred Products for Portfolios
<b>Cash</b>	Very Overweight	AAA rated CMTs
<b>Australian Fixed Interest</b>	Neutral	CFS Australian Bond Fund
<b>International Fixed Interest</b>	Slight Underweight	EQT PIMCO Global Bond Fund
<b>Australian Shares</b>	Neutral	Ausbil Australian Active Equity Fund IOOF Perennial Value Shares Fund Tyndall Australia Share Portfolio IML Australian Share Fund BT Core Australian Share Fund Eley Griffith Group Smaller Companies Fund
<b>International Shares</b>	Neutral	Zurich International Share Fund AXA Global Equity Value Fund Barclays International Share Fund
<b>Property Trusts</b>	Underweight	AMP Core Property Fund ING Global Property Securities Fund

## Australian Dollar



Source: Lonsec Managed Funds Research, Data source: RBA

### Review of Quarter

The Australian dollar (AUD) fell by -0.1% against the US dollar (USD) in the December quarter, closing at US\$0.8827 (US\$0.8827 at the end of September, *Source: RBA*). This follows a rise of 4.0% in the September quarter. Against the Trade Weighted Index, the AUD appreciated by 1.8%.

The AUD strengthened against most major currencies across the board in October. For the first three weeks of the month, however, the AUD remained in a tight range between US\$0.8795 and US\$0.9080, largely consolidating after the strong monthly gain in September. The intra-day monthly low in the AUD of US\$0.8753 occurred on October 22, coinciding with the monthly low in the US Dow Jones stock index, as a temporary rise in risk aversion marked the 20<sup>th</sup> anniversary of the October 1987 stock market crash. A combination of stronger than expected domestic economic data (Q3 CPI, September building approvals and credit data) triggered speculation about a near-term interest rate rise by the RBA, and a batch of weak US economic data (in addition to an interest rate cut by the US Fed Reserve to 4.50%), saw the AUD post solid gains late in the month, closing at US\$0.9216.

The AUD fell heavily against almost all major currencies during November, led by heightened risk aversion amid growing losses from the US sub-prime sector, downgrades to US financial sector companies, increased volatility and a rise in concerns for global growth. These concerns saw the AUD hit an intra-day monthly low of US\$0.8655 on November 21. In a volatile month, the AUD touched an intra-day (and 23-year) high of US\$0.9400 on November 7 following a 0.25% rate rise by the RBA to 6.75%. Improvement in risk appetite (driven by increasing market expectations of a December 11 US

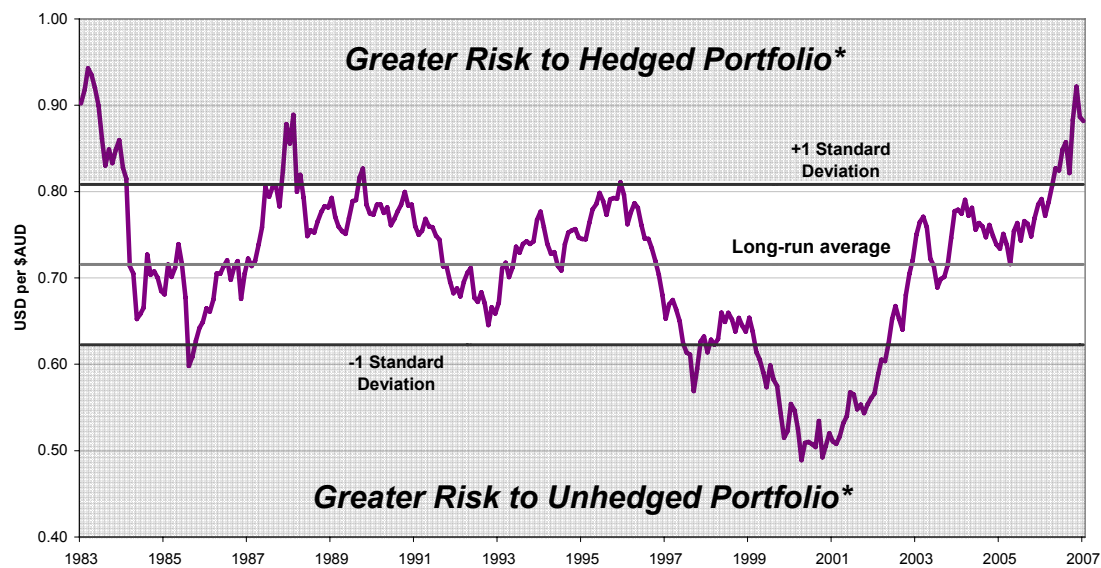
Federal Reserve rate cut) directed the AUD higher in the final days of November, closing at US\$0.8865.

Whilst the AUD fell marginally against the USD in December, over the 2007 calendar year the currency gained 11.4% against the greenback. The monthly high in the AUD of US\$0.8907 came on December 13 after stronger than expected domestic December employment numbers. USD strength pushed the AUD lower mid-month upon the release of stronger than expected US November retail sales (double what was forecast) and CPI data. Conversely, a batch of disappointing US economic data over late December saw the USD come under downward pressure and the AUD recover some lost ground. The AUD finished the quarter and year at US\$0.8816.

The above chart shows the performance of the AUD during the December quarter. As can be seen, the AUD experienced a volatile quarter, trading between a range of US\$0.8578 and US\$0.9376 during the quarter.

The chart overleaf shows the movement of the AUD versus the USD since the float of the AUD in December 1983. Assuming mean-reversion, the risk of (un)hedging is greater when the currency has moved above or below 1 standard deviation of the long-run average. The exchange rate between AUD and USD was chosen as the MSCI World index has over 50% exposure in USD. Despite a volatile quarter, the AUD finished the December quarter at US\$0.8816, representing close to 2 standard deviations above the long-run average since December 1983.

Exchange Rate  
December 1983 to December 2007



\* Based on historical data and assuming mean-reversion, the risk of (un)hedging is greater when the currency has moved above or below 1 standard deviation of the long-run average

## Outlook

Since September the US Federal Reserve has cut interest rates by a total of 1.00% to 4.25% in response to the housing slump and credit market turmoil, but the near doubling of the oil price over 2007 has re-ignited inflation fears and could put a halt to any further cuts. Renewed inflation fears would limit the easing of monetary policy and would dramatically shift the economic responsibility over to fiscal policy and the US Government. Generally, the US economy is in average to poor shape with the main negatives being a troubled housing market (rising foreclosures, falling house prices and rising house stocks), a large Current Account Deficit (6% of GDP) and a Federal Government Budget Deficit (2.5% of GDP). The positives, at the end of the September Quarter, were good levels of consumption, corporate profitability, business investment, employment and export growth but the downside risks to consumption are increasing, due mainly to the housing slump, tightening credit conditions and rising oil prices.

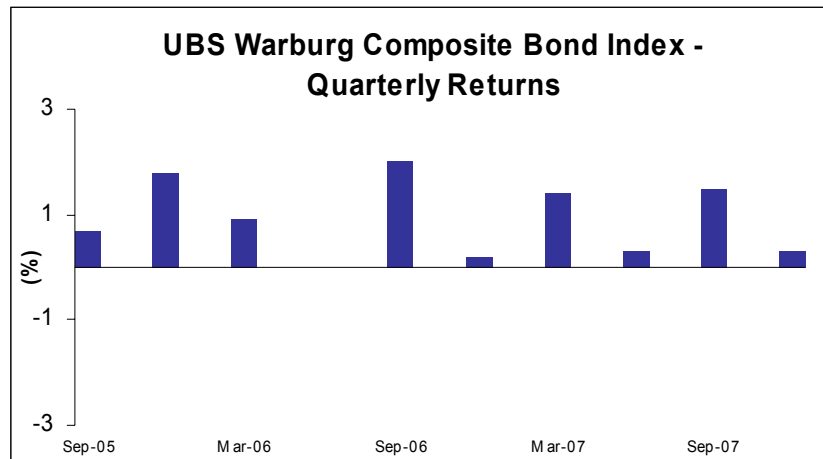
On the domestic front, the economy continues to experience very strong growth (albeit moderating) with the major risks being inflation and the impact of a major slowdown in the US on our major Asian trading partners. Demand is strong across the board with Consumption, Government spending, Business Investment and Net Exports all contributing to growth. Households are enjoying strong income growth and rising wealth, while company profits remain strong and balance sheets are in good shape. With strong growth, a strong fiscal position, rising interest rates, firm commodity prices, improving terms of trade and the aforementioned slowing US economy, the AUD is expected to have more upside than downside versus the USD over the near term. That said, downside risks to the AUD versus the USD include Australia's high Current Account Deficit (6% of GDP), any major fall in key commodity prices (iron ore, coal), any flight to quality event (i.e. recent credit crunch sell-off) and any major unexpected recovery in the US economy.

## Australian Cash

The Australian cash market continued to deliver a consistent return of 1.74% for the December 2007 quarter. Over the 12 months to December 2007, the cash market returned 6.73%. The official cash rate stands at 6.50% and 90 day bank bill yields rose 35 basis points, closing the quarter at 7.24%.

Lonsec approaches its cash exposure as a residual of its views on the outlook of the major asset classes – fixed interest, Australian shares, listed property and international shares.

## Fixed Interest



Source: Lonsec

### Review of Quarter

The end of the December quarter marks the close of a difficult year for capital markets. This was the year that sub-prime — a little-known segment of the US mortgage market — entered everyday language. The collapse of this market segment has been blamed for sparking the bushfire that has spread across world financial markets.

Domestic fixed interest<sup>1</sup> treaded water this last quarter, delivering a miserly 30 basis points (bps). In fact, its annual performance vs. cash has been disappointing and highlights the difficulties faced in world capital markets this year, which are more pronounced with close market integration. Domestically, in 2007 cash<sup>2</sup> outperformed fixed interest by almost a factor of two: 6.7% vs. 3.5%. International markets were also weak. ‘Vanilla’ sovereign debt<sup>3</sup> returned 3.04% during the last quarter and 6.45% for the calendar year. Mixed (sovereign, credit and ABS) international debt<sup>4</sup> finished off the quarter with 2.84%, and returned 5.85% over the year.

### Monetary Policy

The Reserve Bank of Australia (RBA) created history when it raised the cash rate target by 25bps (in November 2007 to 6.75%) during a federal election campaign. This is the first time it has ever taken such action. This move was seen by many industry participants as the RBA’s ‘coming of age’ and assertion of its independence from government. That said, the market had largely factored in such a move, meaning no action from the RBA would have created the most commotion inside investment circles. This was only the second move in the cash rate in the calendar year.

Australia’s recent monetary policy action is in stark contrast with that of other developed economies, which eased rather than tightened. In the US, following the dramatic 50bps reduction in the previous quarter, the Fed reduced the federal funds rate by 25bps in each of October and December, closing off the year at 4.25%. It is important to remember that, prior to the market disruptions associated with the credit crisis, the general feeling from market participants was that the most likely Fed action, if any, would be a tightening. This turnaround underscores the gravity of the situation facing the US, which is also being challenged on other fronts, e.g. rocketing oil prices.

The Bank of England (BoE) also cut rates during the quarter, marking the first easing after a trend of increases throughout the year. The European Central Bank (ECB) left rates on hold this quarter at 4.00%, after two prior increases at 25bps each throughout the year. The Bank of Japan (BoJ) has also kept rates on hold at 0.50%, following February’s 25bps increase.

### Credit markets

During this quarter some of the ‘titans’ of Wall Street were truly shaken. Merrill Lynch and Citigroup both announced the departures of their CEOs, following unexpectedly high write-downs on assets linked to the US sub-prime market. Citigroup, Morgan Stanley and Bear Stearns faced the ignominy of negative ratings actions. UBS also announced significant write-downs and proceeded to shore up its capital through equity placements with the Singapore government and unidentified Middle East investors.

In the UK, the rescue package for Northern Rock (which experienced a ‘bank run’ in the September quarter — the first in almost 150 years in the UK) continued to be negotiated. HSBC also faced some negative sentiment from the rating agencies.

<sup>1</sup> UBS Composite Bond Index – All Maturities

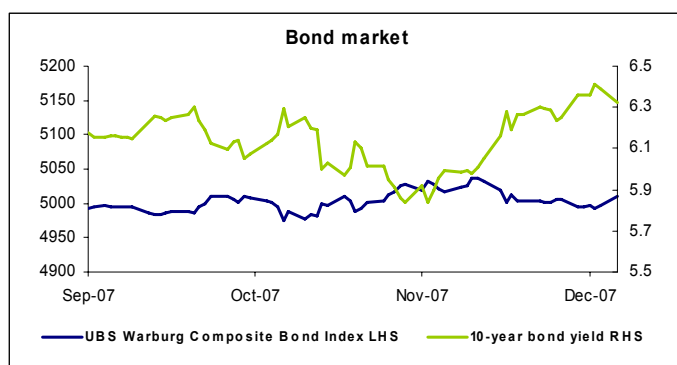
<sup>2</sup> UBS Bank Bill Index

<sup>3</sup> JP Morgan World Government Bond Index Hedged A\$

<sup>4</sup> Lehman Global Aggregate Index Hedged A\$

At home, RAMS completed the sale of its distribution business after experiencing difficulties in securing financing to roll over existing debt. A similar issue is currently facing the listed Centro group, news of which bubbled to the surface late in the December quarter. The RAMS and Centro issues highlight the risk aversion gripping the capital markets in the US. More significantly though, financial insurers like PMI (mortgages) and MBIA (bonds) have been caught up in the sub-prime domino effect. Credit rating agencies negatively revised their outlooks due to the increased potential for their sub-prime related liabilities to be called-in thereby impacting their capital position and putting at risk the tacit ratings of insured paper.

Understandably, with all this action and uncertainty, credit spreads have jumped from their previous very low levels. Domestic spreads over swap rates for AAA, AA and A rated corporate bonds jumped 18bps, 38bps and 40bps respectively year-on-year to November 2007. Put in perspective, this represents increases of 211%, 372% and 160%.



Source: Lonsec

Gyrations in the 10-year Government bond yields over October were influenced by pressure on interest rates from macro factors. In particular, higher than expected inflation numbers late in the month caused some consternation. Yields were compressed below 5.9% during November 2007, following the lead of similar downward moves in US yields, based on macro economic fears and challenges to corporates. Over December the US continued to experience similar concerns to those in November. At home, the domestic market broke with the US, supported by Australia's superior economic prospects and higher inflation outlook, which contributed to yields creeping up.

## Fixed Interest Outlook

The Australian economy is expected to continue to grow moderately, which should continue to place pressure on inflation and interest rates. Australia's close integration to the world economy, which is expected to soften through 2008 on the back of a slowing US, is a 'wildcard'.

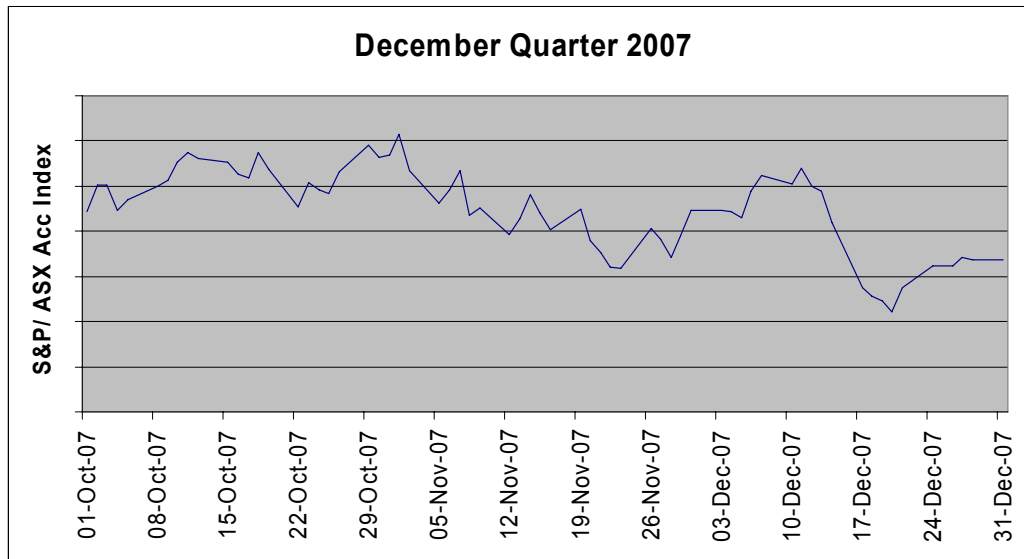
The US still remains a key part of the global economy, particularly as an export market, and any recession would likely reverberate throughout the world. After initial reticence in resorting to official rate-cutting as a means to soothe harried capital and equity markets, the US Fed succumbed again in the September and December quarters. It also tried a number of new tricks: it reduced the rarely used discount rate and broadened the types of acceptable securities as collateral from banks. These were seen as pinpoint measures to restore liquidity to capital markets and reprise economic prospects without resorting to blunt official interest rate moves. The Government is also weighing in, and most recently President Bush raised the prospect for fiscal stimulus to support the economy. An announcement is expected during the State of the Union address scheduled for January 2008. Lonsec believes that, at present, there is an even chance that the US will slip into recession during 2008.

## Portfolio Action

Lonsec has improved its view of Australian fixed interest resulting in a shift to a 'neutral' weighting. This represents an up-tick from the previous 'underweight' position and is reflective of a broader defensive portfolio view. We have seen the domestic yield curve flattening over recent months as bond yields have been rising on inflation concerns. For example, 3 and 5 year bond yields are now at near the cash levels (90-day bank bills at 7.18%) both at 6.90% and 6.72% respectively. We are of the opinion that this asset class is showing improving valuation vis-à-vis cash.

Conversely, we do not consider international fixed interest to currently be as attractive, on a relative basis. The August 2007 credit crisis-induced 'flight to quality' has pushed down the benchmark 10 year bond yields across the major markets of US, UK, Germany and Japan. Accordingly we have maintained the 'underweight' position to international fixed interest.

## Australian Shares



Source: Lonsec, Data source: IRESS

### Review of Quarter

The Australian share market posted a negative return for the December 2007 quarter, with the S&P/ASX 300 Accumulation Index falling -2.7% for the period, its first negative quarterly return in over 12 months.

Notwithstanding this, over the one year to 31 December 2007, the S&P/ASX 300 Accumulation Index returned a strong 16.2%.

The Australian share market has not been immune to events occurring around the globe, and this was clearly evidenced by the negative performance over the December quarter. Share markets both here and abroad have been affected by the uncertainty surrounding economic conditions in the US (which represents approximately 26% of the global economy) and fears of a possible recession. This uncertainty has stemmed primarily from the sub-prime debt crisis, and whilst the fallout continues to have a direct impact on global credit markets, global equity markets have also experienced higher levels of volatility and shifts in investor sentiment. The Australian share market peaked during the December quarter at 6845 points on 1 November and appeared to be on track for posting another quarterly rise. The share market rally over this period, however, was driven by a small number of large cap stocks (namely BHP, RIO, WOW and CBA). The rally proved to be unsustainable and resulted in the broader Australian share market finishing the December quarter in negative territory. Attempts by the US Federal Reserve to restore investor confidence (via 0.25% interest rate cuts in October and December) also provided only short-term relief for equity markets. On the domestic front, the latest casualty from the sub prime debt crisis was Centro Properties Group (CNP). CNP announced a downgrade to its earnings forecast, citing higher funding costs, and

its share price subsequently declined by approximately 86% over the quarter. Highly geared companies will remain in the spotlight while the global credit crisis continues.

The Australian share market outperformed two of the four major international regions (in local currency terms) during the December quarter, with Asia and Europe posting returns of -0.3% and -1.5% respectively, while the US and Japan delivered returns of -3.1% and -8.8% respectively. Over the year to December 2007 the Australian market (+16.2%) underperformed Asia (+30.4%), but outperformed the regional markets of Europe (+6.0%), US (+5.8%) and Japan (-10.2%).

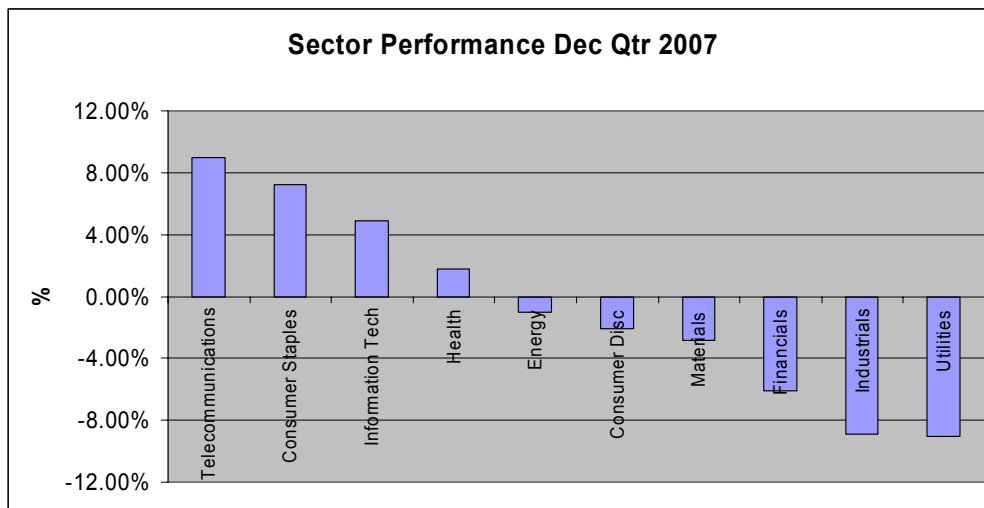
As shown in the chart above, the latter part of the December quarter saw the Australian share market retreat. Not only did the share market continue to experience high levels of day-to-day volatility, but it also experienced periods of severe intra-day volatility (moves in excess of 100 points). The mid-December period was particularly volatile, resulting in an -8% decline in the share market over the course of seven consecutive trading days. Ongoing global credit concerns, higher oil prices, and risks of a further tightening by the RBA, had a negative impact on the share market and contributed to this volatility. Merger and acquisition activity remained present during the quarter, but centred mainly on the resources sector and BHP Billiton's (BHP) proposed \$171 billion takeover offer for Rio Tinto (RIO). This takeover is expected to remain a major theme heading into 2008.

**Stock Performance**

Over the 2007 year the five best performing ASX 200 stocks (in terms of share price movement) were Fortescue Metals (+465.1%), Sundance Resources (+388.6%), Incitec Pivot (+232.1%), Mount Gibson Iron (+215.7%), and Pan Australia Resources (+214.29%). Worthy of note is that four of the top five performing stocks (excluding Incitec Pivot) are in the resources sector, and operate in either the iron ore or gold industries. Fortescue Metals is involved in the exploration, and development of iron ore in Western Australia, and its share price has risen as a result of the bullish outlook for iron ore and the demand for resources from China.

Conversely, the five worst performing ASX 200 stocks over the 2007 year (in terms of share price movement) were Centro Properties (-88.9%), Boom Logistics (-54%), Centro Retail (-52.9%), Perilya (-51.8%), and Allco Finance Group (-51.7%). Centro Properties Group has investments in retail shopping centres in Australia, NZ, and US and has revised down its earnings forecasts due to tightening global credit conditions and higher funding costs.

**Sector Performance**



Source: IRESS

Telecommunications was the best performing sector for the December 2007 quarter (+8.9%), ahead of the consumer staples sector (+7.2%). As can be seen from the chart above, these two sectors, along with the information technology sector, were the better performing sectors over the quarter. Telstra (TLS) in particular performed well (+8.8%), driving much of the telecommunications sectors gains, as the volatile share market conditions favoured stocks with relatively defensive characteristics. This sector's performance was in contrast to previous quarters, which have been dominated by the materials and energy sectors. Interesting to note is that over the course of 2007, BHP and RIO contributed 52% of the markets total gains.

Examples of stocks which were the key drivers for gains within the consumer staples sector include Woolworths Limited (WOW) and ABB Grain Limited (ABB). WOW shares rose by +14.3% for the quarter, whilst ABB shares rose by a solid +7.5%. WOW announced a positive first quarter sales report and expects to maintain its sales outlook for the full year, while ABB's share price benefited

by meeting its previously revised earnings expectations, and from its inclusion in the S&P/ ASX 200 index. The industrials and utilities sectors lagged the rest of the market over the course of the quarter, returning -8.9% and -9.0% respectively.

**Outlook**

Lonsec remains cautious on the outlook for the local share market. Rising interest rates and a slowing US economy are expected to provide the domestic share market with headwinds over the course of 2008. The market is not expected to match the impressive double digit returns of the past five years, and instead Lonsec expects the market to trade within a range of 6,000 to 6,800 points. However, Lonsec expects the Australian economy to remain in relatively good shape, due to our exposure to the growing Asian economy. Increasing wages and higher oil prices are expected to place further pressure on inflation, and Lonsec therefore continues to believe that inflation is a key risk for the share market.

The RBA last raised interest rates by 0.25% in November to 6.75%, and may be required to raise interest rates further in order to ease some of these inflationary pressures. Lonsec expects continued share market volatility, both domestically and abroad, until these risks have abated and a clearer picture can be painted for a recovery in the US economy.

Whilst a strong domestic economy has resulted in the share market finishing the calendar year in positive territory, this has not been without some extreme volatility. As experienced this quarter, Australia will continue to be affected by events around the globe. Uncertainty remains as to how extreme the economic slowdown will be in the US, and what the implications will be for the broader global economy. Considering that 63% of Australia's exports are to the Asian region, a key issue for the Australian economy and share market will be whether the developing markets of Asia can withstand a US slowdown. Australia's resources sector in particular, which contributed to a large part of the share markets gains (particularly in 2007), is largely dependant on the Asian 'growth story'. In Lonsec's view, Asian economic growth (excluding Japan) is expected to slow but still remain relatively strong.

Overall, Lonsec believes that the share market has reasonable earnings prospects for 2008 with broker consensus EPS growth to be in the range of 8% to 10%. Lonsec however believes that the market has already priced in this growth and that valuations, particularly in the industrials sector, seem fully priced. Rising costs and a stronger AUD are expected to take some shine off the resources sector, and EPS growth is expected to be in the range of 10% to 15%. In the Financials sector, overall earnings growth of 10% is forecast, and the major Banks are expected to fare better than Insurers and Wealth Management firms.

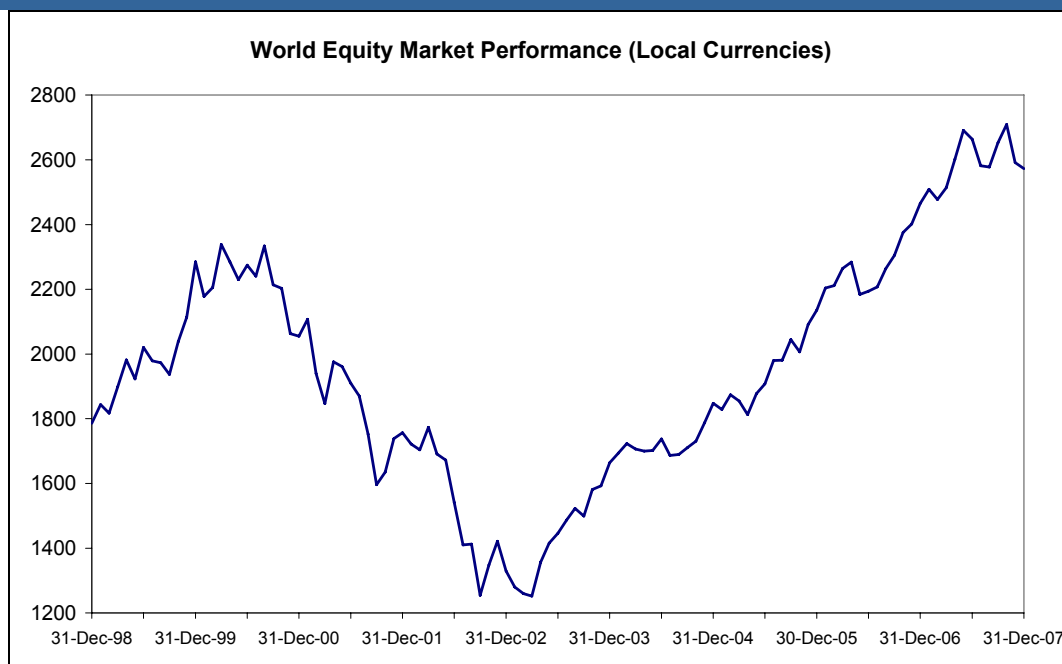
## Portfolio Action

Given that Lonsec expects global growth to weaken over 2008, particularly in the developed economies of the US and Japan, we have reduced our recommended asset allocation in international equities to 'neutral' (from 'overweight'). In Australian equities, Lonsec has maintained a 'neutral' weight to this asset class as solid contributions from the Asian and emerging economies should continue to offset some of the slow down from the US. Whilst global growth is expected to slow from 5.1% to 4.1%, Lonsec acknowledges that this is still a solid growth rate. Lonsec, however, has decided to take a more defensive stance, and this is reflected in the decision to move to a 'neutral' weight for international equities and in maintaining a 'neutral' allocation to Australian Equities. This is due to the aforementioned heightened uncertainties.

As mentioned earlier, some segments of the Australian share market appear to offer better value than others. For advisers who wish to tailor their tactical equity decisions further, Lonsec recommends the financials and resources sectors ahead of the industrial sector primarily based on forecast earnings growth and current valuations. In relation to managed funds, investors should ensure that they give due consideration to the balance of 'value' and 'growth' style investments in their portfolio, and be cautious of adopting any major bias to either style on the basis of short-term outperformance of one versus the other.

Lonsec's most preferred Australian equity funds are the **ABN AMRO Australian Equity Fund, Ausbil Australian Active Equity Fund, IOOF Perennial Value Shares Fund, IML Industrial and Australian Share Funds, BT Core Australian Share Fund** and the **Tyndall Australian Share Wholesale Portfolio**.

## Global Equities



Source: Lonsec

### Review of Quarter

The uncertainty and volatility afflicting global markets heightened during the final months of 2007 as a chain of weak economic data emanating from the US weighed heavily on investor sentiment. All regional markets (US, Europe, Japan and Asia) moved lower during the last quarter of 2007 (in local currency terms). Overall, international shares fell by -2.2% in the quarter and ended the calendar year -2.6% lower.

Concerns about contracting global economic growth gradually deepened as the year progressed. Despite this, most major global markets managed to achieve positive returns over the past year. Asia was the standout performer, rising by 30.4% followed by Europe (6.0%) and the US (5.8%). Japan was the exception with shares falling by -10.2%, in local currency terms, in 2007. This disappointing performance contrasted with the good returns across the broader Asian region. The difference, in local currency terms, between the best (Asia) and worst (Japan) performing region for 2007 was a substantial 40.6%.

In stark contrast to the 12 month return of the MSCI World Ex-Australia Index (-2.6%) the Australian market (S&P/ASX 300 Accumulation Index) returned 16.2% over the same period. The rising Australian dollar meant that currency movements continued to have a bearing on the disproportionate returns for hedged versus unhedged investors.

The Australian Dollar endured mixed fortunes against the major currencies during the quarter. The AUD was broadly flat against the USD (-0.1%) as the currency's rising trend was halted by weaker demand for higher

yielding currencies with global investors paring back their risk appetite. The currency also weakened against the JPY (-2.8%), though it was a particularly volatile quarter with the Australian dollar reaching a 16-year high against the JPY in November before sliding more than ten percent. The AUD weakened against the EUR (-4.0%) but appreciated against the GBP (1.0%) with concerns about the UK economic outlook dragging on Sterling.

Considering currency movements on a yearly perspective, 2007 proved another strong year for the local currency against a broad basket of cross rates. The conditions were favourable for the Australian dollar, which is often tagged a commodity currency and tends to do well when there is strong demand for natural resources. The AUD rose against the USD (11.4%), GBP (9.4%) and JPY (4.9%) while largely holding its own against the EUR (-0.5%).

### United States

The fourth quarter is traditionally the strongest trading quarter of the year but US shares failed to match this historical trend, finishing down -3.1% for the quarter. It proved another volatile quarter for US investors, with the Dow Jones Industrial Average rallying at the beginning of October to reach a record high of 14,164 on 9 October before falling nearly ten percent to 13,264 at year end. Factors influencing the sharp fall included poor US corporate earnings figures in banks (financial stocks were particularly hard hit) and homebuilding stocks, very weak housing data, falling consumer sentiment (reflected in flat retail sales figures), the prolonged impact of the liquidity squeeze and, to some extent, reaction to the Federal Reserve's monetary policy action.

The damaging fallout from ill-advised and unsustainable lending practices continued to cast a shadow over the global financial sector during the quarter, particularly in the US. A number of prominent investment banks, including Citigroup, Merrill Lynch, Morgan Stanley and UBS, announced multi-billion dollar earnings write-downs that largely served to erase quarterly profits. The disastrous performance was not without consequence, with some boards taking the opportunity to remove those at the helm while other CEOs retained control but *graciously* declined an end-of-year bonus.

## Europe

European shares fared slightly better than the US but fell -1.5% for the quarter as fears about a weakening US economy's impact on global economic prospects took centre stage. All major European indices experienced a turbulent second half of the year.

## Japan

The European experience was mirrored and magnified in Japan as it recorded the largest quarterly fall of regional markets, declining -8.8% for the quarter. This was a disappointing return for Japanese investors as concerns about the economic outlook combined with an uncertain domestic political situation.

## Asia

In a recurring theme present throughout 2007, investors in Asian markets fared better than their global counterparts with Asian equities only marginally falling -0.3% over the quarter.

## Outlook

Global growth is expected to moderate in 2008, falling from 5.1% in 2007 to 4.5% in 2008 according to IMF forecasts, primarily driven by recent US economic performance, the increased likelihood of a sustained slowdown in the US and the associated possibility of a recession. The deterioration in the US housing sector appears yet to have fully troughed and the negative fallout is influencing other segments of the economy, including consumer sentiment and retail spending. Accordingly, Lonsec expects the US to weaken further over the near term, resulting in a reduction in our global economic growth forecast from 5.1% in 2007 to about 4.1% over FY08. While it is unlikely that China, India and other East Asian economies can continue to grow at existing levels in the face of weaker demand from developed economies, the regional outlook remains positive with these economies expected to provide some cushioning effect to the global economic slowdown.

## United States

The US Federal Reserve (the Fed) continues to be preoccupied by the deteriorating domestic economic situation and efforts to counteract the crippling developments in credit markets. The Fed lowered the key Federal funds rate by 0.25% to 4.5% on 31 October and its rhetoric seemed to favour a more neutral monetary policy stance, being concerned about a schizophrenic scenario of rising inflation (increasing fuel and food prices) and a contracting economy (weakening labour market). The policy makers' tone indicated that perhaps their recent easing phase might be sufficient to ride out the housing and credit malaise.

However, the Fed seemed to have misjudged the depth of the correction as the economy continued to weaken, prompting it to trim the key rate by a further quarter percentage point to 4.25% at its December meeting. There is now some expectation that rates may continue to ease by as much as 1% during 2008.

The ongoing resetting of sub-prime mortgages will continue to impact both the US and global economies over the coming months. It remains to be seen whether the worst has been factored into balance sheets and whether the outlook for financials will stabilise; however, there remains a general nervousness that the impact of the sub-prime mess will continue to influence the corporate landscape well into 2008. At the same time a number of institutions benefited from an uncharacteristic trend, receiving equity injections from Asian and Middle East-domiciled sovereign wealth funds. Such funds have recently swollen thanks to favourable domestic trading conditions (including in some cases a \$100 oil price), and these buyers have taken the opportunity to lodge significant interests in blue-chip global financial corporates at attractive valuations.

## Europe

The European Central Bank (ECB) bucked the trend of major central banks cutting rates, by leaving the borrowing rate unchanged at 4.0% during the quarter. Indeed, the Bank said it was more disposed to raising rates in the near term than cutting, with inflation being above its comfort zone of 2%, on the back of higher food and oil prices. Broadly, the European economy continued to grow at a reasonably healthy pace with the ECB projecting annual real GDP growth of between 2.4 to 2.8% in 2007, though it did concede a weaker growth outlook in 2008 (1.5-2.5%).

There were mixed fortunes across the Eurozone as economies grappled with the global financial crisis. Germany has enjoyed two years of robust economic growth and a return to its status as the powerhouse of Europe. The German economy grew by 0.7% in the 3<sup>rd</sup> quarter and is expected to expand 2.5% for the year, according to the European Commission. However,

growth is expected to slow in 2008 as the economy confronts rising inflationary pressures. The UK economy finished the year on a cautious note amid growing concerns about an economic downturn due to the ubiquitous themes of tight credit markets and declining consumer confidence. The British Government revised down its 2008 GDP forecast in October to between 2% and 2.5% from 2.5% to 3.0%. Average house prices in the UK fell in successive months in the quarter as confidence in the British housing market waned throughout the second half of the year.

Meanwhile, in France the new administration encountered a serious test of political resolve as a nine-day public rail strike brought severe economic disruption in November. The economic outlook is clouded with further disruption forecast in 2008 as President Sarkozy seeks to improve French productivity while dismantling entrenched institutions like France's generous public pension scheme. Not surprisingly, the reforms are supported by the business community, but keeping public opinion onside will be critical to both maintaining momentum and achieving success.

### Japan

The Bank of Japan left rates unchanged at 0.5% for the 12<sup>th</sup> straight session at its 20 December meeting and lowered its view on Japanese growth largely on the deteriorating outlook for the US economy. There is little expectation of a rate hike in the near to medium term. The Japanese stock market struggled in 2007, with many foreign investors departing, due in some part to the uncertain domestic political outlook. The ruling government party lost its upper house majority, resulting in a stalled business reform agenda.

### Asia

The outlook remains brighter in the higher growth emerging economies of Asia. Growth in India, China and the rest of East Asia is expected to slow during 2008, but still remain strong. According to IMF forecasts, China's growth rate is expected to slow from 11.5% to 10.0%, India's from 9.0% to 8.4% and the remaining East Asian region from 5.2% to 4.9%.

The Chinese Government expects the economy to grow by 10.8% for 2007. As another remarkably strong year of economic performance drew to a close, government officials cited the familiar themes of inflation and the risk of economic overheating as the major risks moving into 2008.

### Portfolio Action

Lonsec has lowered its weighting to international equities from 'overweight' to 'neutral', based on the worsening outlook for the global economy.

US economic signals suggest the deteriorating business climate is not confined to the housing and financial sectors. This seems likely to have an unavoidable dampening effect on global growth in the large developed economies of Europe and in the world's second largest economy, Japan. Lonsec notes that the 'BRIC' and emerging Asian growth economies are perhaps less reliant on US trade than in previous economic downturns and generally exhibit stronger economic fundamentals such as low inflation (outside China), strong domestic demand, large foreign reserves and current account surpluses than previously. The strength of these economies could provide some offsetting effect in sustaining global growth, particularly those with strong domestic segments (e.g. India and China) compared to those more reliant on foreign trade (e.g. Singapore and Korea). However, US stocks comprise around half of the MSCI World Index and a slump in US economic activity will undoubtedly depress shareholder returns in the US and beyond.

Following the bursting of the tech bubble, international share investors have experienced nearly seven years where 'value'-oriented strategies (e.g. seeking undiscovered or beaten-down companies, typically with low price to earnings ratios) have outperformed 'growth' style strategies (e.g. seeking companies with above average earnings growth and profits and typically higher prices relative to earnings) in international shares. However, 2007 was a year favouring 'growth' managers over 'value' managers. This serves to highlight the need for managed fund investors to ensure appropriate balance of 'value'/'growth' style investments within portfolios to ensure investors have appropriate opportunity to participate in a full range of market scenarios.

## Listed Property

### Australian Listed Property Trusts (LPTs)

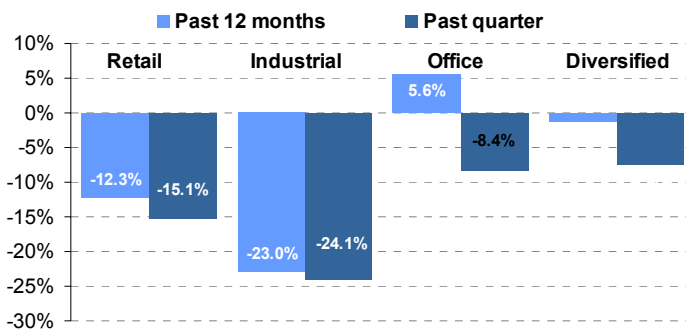
Over the three months to December 2007 the LPT sector has been severely affected by the credit crisis, which has seen the availability of debt finance reduce and interest costs increase. Whilst initially the debt crisis predominantly affected sub-prime loans, this spread to the Commercial Mortgage Backed Securities (CMBS) market and has also seen banks become increasingly more conservative with regard to their required collateral and risk premiums on their lending.

The most affected LPT was the **Centro Properties Group (CNP)**, after it announced that it had not yet been able to refinance \$2.7b of maturing debt facilities. CNP also announced an earnings downgrade, suspended its December half distribution and announced a strategic review of the group. This saw its price reduce from \$5.70 just prior to the announcement on the 14 December 2007 to \$1.01 as at 31 December 2007.

Overall the S&P/ASX 300 Property Trusts Accumulation Index posted a total return for the December quarter of -13.0%, which represents a massive underperformance of the broader equity market of -10.3%. This brings the Australian LPT sector's 12 month total return to -8.36%.

The worst performing sub-sector over the last quarter was Industrial (-24.1%), which was affected significantly by the price fall of the **Goodman Group (GMG)** and the **Mirvac Industrial Trust (MIX)**. All sub-sectors recorded negative returns over the December quarter, with Retail returning -15.1%, Commercial -8.4% and Diversifieds -7.3%.

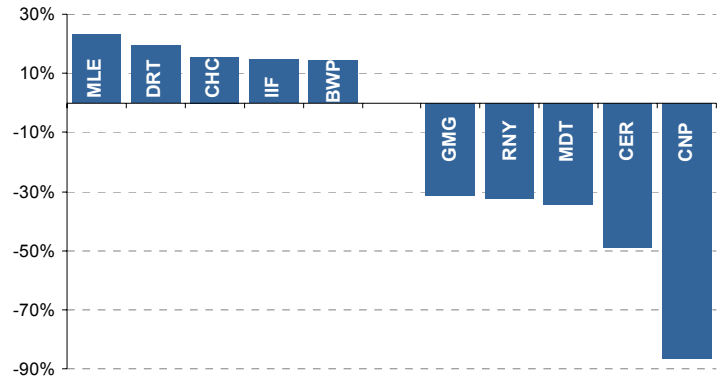
### December Quarter Sub-Sector Total Returns



Highly geared LPTs, particularly those with exposure to the weakening US economy, have been the hardest hit over the last quarter (**Macquarie DDR Trust** and **Reckson New York**). Furthermore, LPTs exposed to funds management underperformed during the quarter. Those most heavily affected were **Valad Property Group** and the **Goodman Group**.

The following chart highlights the top and bottom five performing LPTs over the three months to December 2007.

### Top/Bottom September Quarter Total Return S&P/ASX 300 Property Index



The yield of the LPT sector has increased to 6.1%, a result of the price falls seen over the last quarter. Nonetheless, the LPT sector's forecast yield is still below the 90 day bank bill rate of 7.2% and the 10 year bond yield of 6.3%.

The sector's current yield of -0.2% points below the 10 year bond rate is materially below its 10 year average of a 1.55% premium. It should be noted, however, that to some extent the reduction in the spread reflects the higher earnings growth potential of the LPT sector, due to the emergence of stapled securities with exposure to relatively higher growth businesses such as development and funds management. Lonsec's five-year forecast average distribution growth for the LPT sector is 4.5% pa.

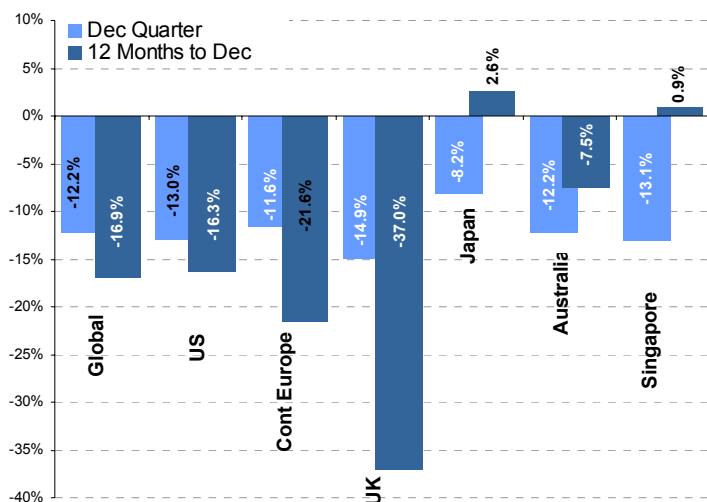
### Global Real Estate Investment Trusts

Globally, listed real estate returned -16.9% over the 12 months to December 2007. The December quarter was particularly volatile, with all regions delivering negative returns.

The worst performing region was the UK, which for a third quarter in a row delivered the lowest returns to finish the year at -37.0%. This is in stark contrast to the expectations of many at the start of the year, when the UK market saw the introduction of REIT legislation.

### Global Listed Property Performance – Dec Quarter

UBS Global Real Estate Investors Index



### Portfolio Action

The Lonsec Investment Committee has maintained an underweight position on property, reflecting the relative unattractiveness of the sector compared with other growth assets, (i.e. domestic and global equities).

The global property sector's returns in 2007 have been impacted by market concerns over rising inflation and the credit crisis, which has seen the availability of finance decrease and the risk premiums demanded by investors increase.

### Outlook

The considerable volatility seen in the global real estate sector over the last three quarters is likely to continue, with the credit crunch potentially having further effects on some of the higher leveraged property stocks. Given the weakening US economy, it is likely that US REITS and property companies with exposure to US assets will continue to experience pricing pressure.

It is likely that the credit crunch (rising funding costs and evaporation of some debt financing), together with continued outflows from property, could see property yields loosen in several key markets (including the UK and the US), which could put further downward pressure on the sector's valuation. Whilst talk of 'yield outshift' has been occurring for a few months now, there is insufficient transactional evidence at this stage to confirm the extent to which this may have already occurred. Lonsec forecasts that over the long term, the global real estate sector will deliver annual total returns of 8-10%.

Domestically, increased financing costs, the strong Australian dollar and its reversionary implications for currency hedging on foreign income, combined with historically low yields, suggest that capital growth from domestic property portfolios will be limited over the foreseeable future.

LPTs with conservative gearing, a focus on quality domestic assets and no exposure to funds management and development activities are likely to be the better performers over the short term. Over the longer term, Lonsec expects that the domestic LPT sector should on average deliver annual total returns of 8-10% pa.

## Analyst Disclosure & Certification

---

Analyst remuneration is not linked to the rating outcome. The Analyst(s) may hold the products(s) referred to in this document, but Lonsec considers such holdings not to be sufficiently material to compromise the rating or advice. Analyst(s) holdings may change during the life of this document. The Analyst(s) certify that the views expressed in this document accurately reflect their personal, professional opinion about the financial product(s) to which this document refers

**Date Prepared: January 2008**  
**Release Authorised by: Richard Everingham**

---

**IMPORTANT NOTICE:** The following relate to this document published by Lonsec Limited ABN 56 061 751 102 ("Lonsec") and should be read before making any investment decision about the product(s).

**Disclosure at the date of publication:** Lonsec receive a fee from the fund manager for rating the product(s) using comprehensive and objective criteria. Lonsec's fee is not linked to the rating outcome. Costs incurred during the rating process of international funds, including travel and accommodation expenses are paid for by the fund manager to enable on-site reviews. Lonsec does not hold the product(s) referred to in this document. Lonsec's representatives and/or their associates may hold the product(s) referred to in this document, but detail of these holdings are not known to the Analyst(s). While Lonsec and the fund manager are members of the Zurich Financial Services Australia group, usual fee arrangements apply and the association did not affect the rating process or outcome.

**Warnings:** Past performance is not a reliable indicator of future performance. Any express or implied rating or advice presented in this document is limited to "General Advice" and based solely on consideration of the investment merits of the financial product(s) alone, without taking into account the investment objectives, financial situation and particular needs ('financial circumstances') of any particular person. Before making an investment decision based on the rating or advice, the reader must consider whether it is personally appropriate in light of his or her financial circumstances or should seek further advice on its appropriateness. If our General Advice relates to the acquisition or possible acquisition of particular financial product(s), the reader should obtain and consider the Product Disclosure Statement for each financial product before making any decision about whether to acquire a product.

**Disclaimer:** This document is for the exclusive use of the person to whom it is provided by Lonsec and must not be used or relied upon by any other person. No representation, warranty or undertaking is given or made in relation to the accuracy or completeness of the information presented in this document, which is drawn from public information not verified by Lonsec. Conclusions, ratings and advice are reasonably held at the time of completion but subject to change without notice. Lonsec assumes no obligation to update this document following publication. Except for any liability which cannot be excluded, Lonsec, its directors, employees and agents disclaim all liability for any error or inaccuracy in, or omission from, this document or any loss or damage suffered by the reader or any other person as a consequence of relying upon it.