



Financially Speaking

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Asia in the aftermath

Recent economic turbulence has shifted opinions on which economies are going to emerge strongest from the global financial crisis. This article explores why Asia may recover faster from the current crisis relative to Western economies and why the region's growth is sustainable in the long term.

Many of the problems seen during the global financial crisis were primarily seeded in developed markets and more specifically their exposure to leverage and derivatives. While Asia has been impacted by the wider economic slowdown it has not experienced the double edged sword of also suffering a deep financial crisis. Asia has largely avoided the financial troubles experienced by Western economies during the global downturn and this is a primary reason why the region may emerge from this period in better condition than others.

Why Asia has remained resilient

The Asian region displayed a fundamentally different financial profile to the developed world coming into the crisis. In many ways the characteristics that make up this profile explain why Asia finds itself in a relatively stronger position than the Western world. These include:

1) Limited exposure to structured debt instruments

Asia's high savings rates mean there is a strong and growing deposit base and less complex loan system. The tendency to securitise loans (combine multiple

loans and sell them) was therefore far less prevalent in Asia than areas such as North America (where mortgage backed securities became an established portion of the financial market). So when defaults occurred in subprime mortgage markets, Asia's lower exposure to this market meant it was less adversely impacted.

2) Robust financial systems

The Asian financial system varies from Western systems in a number of ways:

- A low number of non performing loans (loans that are in or close to default). For example China's ratio of non performing loans reached a low of only 5% of total loans; a level far lower than many developed Western economies¹.
- Recapitalisation of the region in the last decade. One of the consequences of the 1997 Asian financial crisis was for key financial institutions in the region to restructure and actively decrease debt levels. This occurred not only in banks but also in the wider corporate world. As seen in Chart 1 (over the page), net corporate debt levels have steadily decreased in the Asian (ex Japan) region since 1998. This ultimately meant the balance sheets of Asian governments and corporations were in a stronger position going into the crisis.
- Limited reliance on global banks. The relative freeze on inter bank lending as a result of the credit squeeze has had less of an impact on the Asian region due to its relative financial self sufficiency.

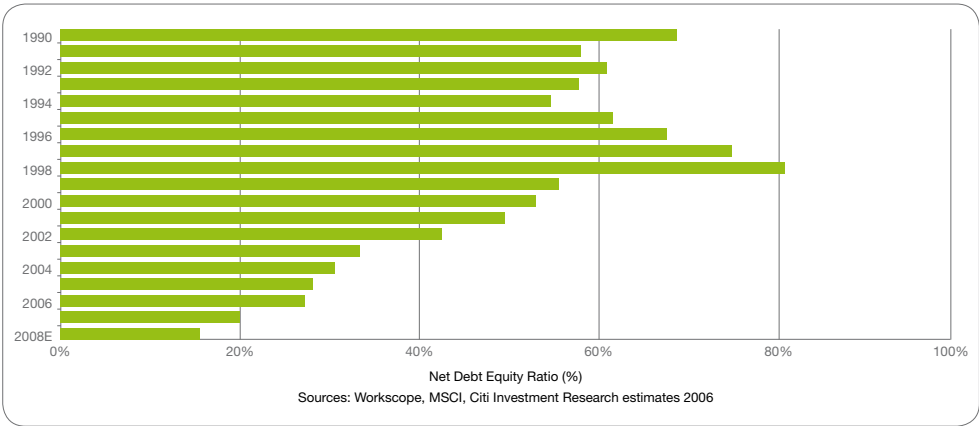
Following the 1997 crisis, which saw many Asian economies collapse because of their dependency on foreign capital, Asia restructured its banking system and adopted a more conservative approach. This included a reduced exposure to global credit markets, which helped isolate Asia from the extreme conditions seen in the West.

3) High personal savings levels

As seen in Chart 2 (below), Asian consumers tend to have high savings rates. This is fundamentally different to the extremely high consumption, high personal debt and low savings cultures of many Western economies. For example, savings rates in Australia in 2008 were only 0.6%². High savings rates in Asia are in many ways a result of limited government social support systems, meaning consumers need to self fund (save) for medical care, retirement and their children’s education.

Asian nations also tend to have low debt levels. Household debt in China is just 14% of GDP versus 104% in Australia and 110% in the UK³. Another reason why household debt levels are relatively low in Asia is the low credit card penetration rate. Consumers in Asia prefer to buy expensive items (like cars and property) outright rather than taking on high levels of debt. Lower levels of household debt in Asia mean there is a less adverse economic impact of the tightening of credit that now constrains many developed countries.

Chart 1: Corporate debt to equity ratios (Asia ex-Japan)



Is Asia’s position sustainable?

Leading up to the onset of the current recession, Asia was labelled as the next engine of economic growth. As demonstrated, the region’s position as a key economic player has only been reinforced by its robust response to current conditions. Irrespective of the current crisis, the core reasons for Asia’s relatively strong growth expectations remain unchanged and sustainable.

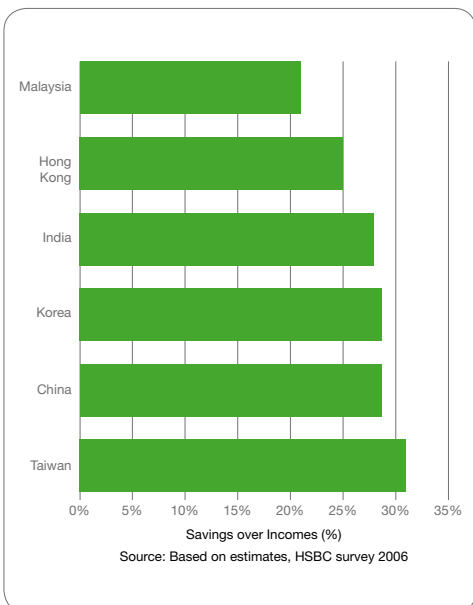
Considering half of the world’s population is concentrated in Asia, it is difficult to ignore the sheer size of infrastructure investment and economic activity that is required to keep growth moving in this region. Financial markets are also beginning to reflect Asia’s dominance, with China and India now representing the third and seventh largest share markets in the world⁴. In addition there are a number of highly

interdependent factors (discussed below and over the page), that lead many to believe Asia will deliver sustained growth.

Urbanisation

The urbanisation rates of China and India, Asia’s two major economies, are only 45% and 30% respectively⁵. Compared to developed countries such as Australia where rates are as high as 90%, there is much greater scope for further urbanisation in Asia. As more people move toward the cities, the economy is stimulated through income growth and increased spending capacity. Further, with urbanisation rates in these countries growing at only 3-4% per annum⁶, it may take decades to reach levels similar to the developed world. This demonstrates the longevity of this type of growth in major Asian economies.

Chart 2: Personal Savings (Asia ex-Japan)



Industrialisation

Rates of industrialisation are closely linked to urbanisation movements. In Australia, 70-80% of the economy is driven by the services industry⁷. In comparison, many Asian economies are still agriculturally driven in terms of their labour force. For example 60% of the Indian labour force is based in primary industry, however only 17% of the economy is generated from this industry⁸.

Countries in the Asian region are now starting to move toward high end manufacturing and tertiary/services industries. Aligned to this is a shift from an imitation to innovation mentality. These countries are now major players in science, technology and IT. The economic growth potential of these industries and their products is based on the fact they require high value add processes giving employees, and the economy as a whole, greater earning potential.

Domestic demand and consumer spending

One of the key pillars supporting Asia's position during this financial crisis has been consumers' tendency to save rather than spend beyond their means.

Now, coming out of the crisis, many Asian governments are looking to boost consumer spending and decrease savings levels to assist economic growth. This is the opposite of the deleveraging trend we are seeing in the West and is evidence of the potential that exists for future spending and growth in Asian economies.

Asia has an attractive combination of a younger demographic base and high GDP growth. Having higher GDP with a working age population means earnings and asset bases will grow at a faster rate. Ultimately, there is greater scope for boosting consumption and wider economic stimulation. Governments in the region have recognised this opportunity and are implementing legislative changes to increase social support to free up household income for greater discretionary spending.

Asia's emergence

Asia's robust financial profile and sustainable growth factors appear to place it in a strong position to emerge from the current crisis in front of other major markets. Asia's limited exposure to structured debt instruments, high savings levels and deleveraged

balance sheets has made the region more resilient to the problems seen in Western markets. In addition, Asia's demographic profile, infrastructure development and relative financial stability may sustain its growth profile and help Asia maintain its label as the engine for global economic growth post financial crisis.

If you're interested in finding out more about gaining exposure to Asia, see your financial planner.

¹'China banks see sharp decline in NPL ratio', China View, 18/01/2009, ed. Bi Mingxin.

²'Forced saving reduces national savings and investment', Kerin, P., The Australian, 02/03/2009.

³Bloomberg, Datastream, AMP Capital Investors, 01/05/2009.

⁴Bloomberg, 10/07/2009.

⁵'India - People' and 'China - People', CIA World Factbook, 01/06/2009.

⁶Ibid.

⁷'Service Industries', Year Book Australia 2008, Australian Bureau of Statistics, p. 591.

⁸'India - Economy', CIA World Factbook, Updated 01/06/2009.

Source: Karma Wilson, Head of Asian Equities, AMP Capital Investors, www.ampcapital.com.au

Risk and return explained

All investing involves a trade off between risk and return. The key is to understand risk, and work with it.

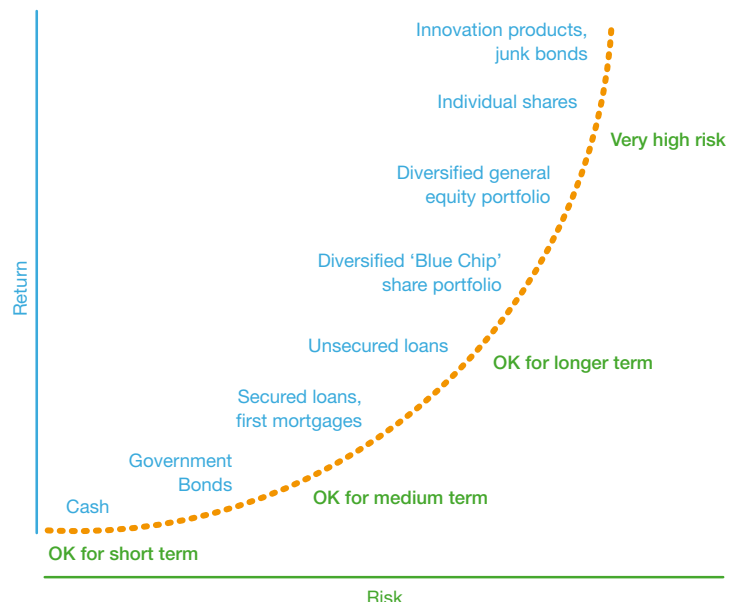
Risk is the chance your investment will lose some or all of its value. Deposit money in a bank account, for example, and there is virtually no risk of your money losing value.

Invest your money in shares, however, and the risk of your investment losing value increases.

The flipside to risk is return — or the potential return you'll receive on your investment. Generally, investments with low risk also generate a low return. Keep your money in a bank deposit and you'll probably earn a return of around 2–3%. Invest your money in shares, and the potential return could be much higher — or lower. It is very important to understand your risk profile, so always speak to a financial planner when making decisions about your investments.

Source: BT Financial Group

As return increases, so too does risk



Source: ASIC FIDO risk and return calculator, available at www.fido.asic.gov.au

Opportunities with global small companies

The global small companies sector will experience significant growth when the global economic recovery gets into full swing. And investors who get in early will reap the greatest rewards.

The case for investing in small companies is well documented. While small capitalisation stocks have traditionally been considered more risky than their large cap counterparts, history has also shown that investors have been compensated for this additional risk through higher longer term returns.

After the 1973-74 recession, small companies in the US outperformed the broader market for 10 consecutive years between 1974 and 1983. The longer term trend has also been impressive. Following the Great Depression, small caps led the market for 11 of the 13 years post 1932. And studies by Ibbotson in the US have found that the annualised return of small cap (value) stocks from 1926 to 2008 was 13.4% versus 9.6% for the S&P 500.

Difficulties with pricing small caps

Two schools of thought exist in trying to explain this small cap effect. The first relates to market participants mispricing the value of smaller companies. The other focuses on a smaller company's vulnerability to the broader economic cycle.

Research and brokerage houses typically concentrate their analysis on larger, better known stocks, which means there is usually a shortage of information at the overlooked, smaller end of the market. A general misunderstanding of a company's business and its potential can lead to attractive purchase prices and ultimately prove

The small cap rebound



quite profitable when the market realises its value. These research gaps can be exploited by fund managers with expertise in the small cap market to create attractive longer term returns.

Another mitigating factor in valuing small companies is that their performance is very closely linked to the economic cycle. As small companies usually have less diversified business lines, their earnings are often dependent on the health of a market or industry.

Clearly this shortcoming can be mitigated through country and asset class diversification.

Poised for growth

The current recession and the lack of credit have created exceptionally harsh operating conditions for smaller companies. Not surprisingly, their share prices seriously suffered as the global financial crisis

unfolded and most mainstream investors shunned risk. But the thing to bear in mind is that small caps tend to perform well when economic conditions improve. And after suffering over the course of the past couple of years, small caps have produced some stunning returns since the market touched its March 2009 lows.

In the quarter ending 30 June 2009, Australian and global small companies have outperformed the broader market by 14.2% and 6.5% respectively. The local sector has put in one of its strongest quarterly rises on record. While there is a risk that some companies may have overshot on the bounce, this strong performance is not entirely surprising.

Diversification benefits

A small caps allocation can provide a portfolio with diversification benefits, as well as potential for higher long term

returns, for investors with an appropriate risk profile. In contrast to Australia, where the small ordinaries index is dominated by small miners, the global small caps universe is spread across more than 3000 companies and 25 countries. It's not dominated by any one sector as is the case here.

What's more, the relative size of some global small companies would place them within the largest 100 listed companies in Australia, meaning that investors can participate in the early stages of growth in world class companies of the future.

Your financial planner can assist you when planning your future and assessing the suitability of small company exposure to your investment portfolio.

Source: Matthew Drennan, General Manager, Zurich Investments

The upside of being on the young side

If you've got more than 40 years until retirement, you have an investing asset money can't buy — time.

And the more time you have, the longer you have to ride out periods of market volatility and even grow your super with the power of compounding.

Compounding is one of the fundamental concepts of building wealth over the long term. Apart from the tax savings, it is the key driver behind superannuation and why the experts tell us it is the best investment vehicle for our retirement savings. Put simply, compounding is interest on the amount you invest, and interest on the interest you earn.

If you're in your 20s, you can use it to do incredible things to your super balance that simply aren't possible for people in their 50s or older.

Compounding in super action

Consider the following example. At the age of 21 you decide to make a personal contribution of \$5,000 into your super and then add to it at the rate of \$1,000 each year — until you turn 30. That's right, just 30. Then you stop making contributions and leave your super alone until you retire at 65. Let's assume that you earn an average of 8% pa after fees and taxes.

Now imagine an alternative scenario...

At the age of 31, you decide to put aside \$5,000 and add \$1,000 each year until you turn 65 in belief that you will make up for lost time by saving harder over 35 years rather than 10 years.

Which is the better strategy?

- The 10 year saving plan, in which you will have invested a mere \$14,000 — a \$5,000 initial contribution then \$1,000 a year for nine years — will earn you an additional \$332,413 in your super.
- The 35 year plan, in which you will have invested \$39,000, nearly three times as much, earns you considerably less: \$227,077.

Make compounding work harder for your super

Here are some of the ways you can take advantage of compounding to grow your super:

- Consolidate your super into one account — the money you save in multiple fees could stay invested and really help grow your overall super balance.

- Add more to your super (if you can) — by adding more money to your account each year — above the 9% you normally receive from your employer — you'll give your super the opportunity to grow faster and bigger.
- Hold your investment over time — if you sell or switch your investments, you'll lose the effect of compounding and may crystallise losses.

The moral here is simple. If you start building your super balance sooner, it has the potential to grow bigger — often with less effort. But if you start later, you may need to contribute a lot more, just to reach the same level.

Speak to your financial planner today about how to make the most of your super.

Assumptions

¹Assumes an initial investment of \$5,000 into superannuation and then ongoing \$1,000 contributions made at the end of each year.

²Assumes 0% inflation and 8% pa average return after fees and taxes.

This scenario has been developed for illustrative purposes only and cannot be relied on as an indication or prediction of future results.

Source: BT Financial Group

Don't forget your life insurance

Did you know?

- There's a \$1.3 billion gap between the life cover Australians have and what they actually need.¹
- There is a one in three chance you will need to be off work for three months due to illness or injury before you turn 65.²

Why do I need it?

Most people don't think twice about insuring their car, home and valuables. But if your ability to work is your major

source of income, it's just as important to protect you and your family so you're covered in the event something happens to you.

The smarter way to get cover

If you haven't already done so, taking out Life Insurance and Total & Permanent Disability (TPD) insurance through your super account could make a lot of sense. There may be tax advantages in it for you and it's easy to set up. Rather than use your after tax earnings to pay your premiums, if you have insurance through your super

fund, your premiums are deducted from your super balance.

This means you won't notice a difference to your take home pay. Even better, you and your family will be financially protected should something ever happen to you.

Speak to your financial planner about choosing the right cover for you.

¹Investment and Financial Services Association (IFSA), Insurance Fast Facts, October 2005.

²Institute of Actuaries of Australia, 2000:Interim Report of Disability Committee.

Source: BT Financial Group

You're a long time retired – make sure you're investing for growth and income

According to the Australian Bureau of Statistics, we're hanging around for longer. Life expectancy for an Australian man is now around 78.5 years, while women can expect to live till they're 83¹. Stop working at 60 or 65 and, statistically speaking, you'll have a long time in retirement.

If you want to make sure your retirement savings last as long as you do, it makes sense to get advice around balancing your retirement savings to generate an income and some growth. A financial planner can help you get the right balance between secure investments, like cash, and more risky long term growth investments like shares. A financial planner can also help you build a financial plan based on your own unique circumstances and retirement goals.

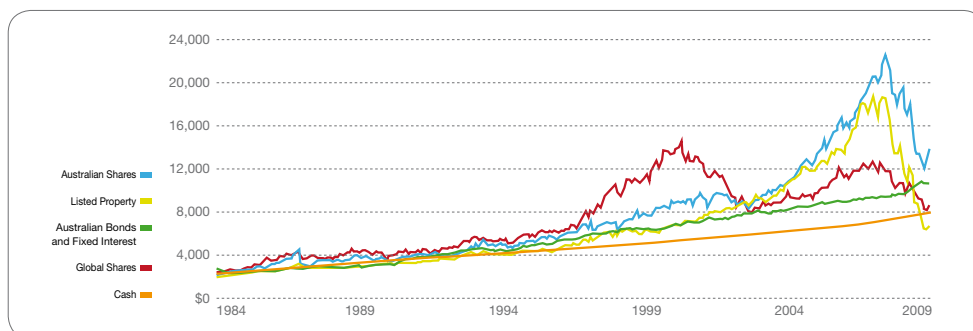
The problems with cash

Cash definitely has a role to play in a portfolio, but over the long term it won't provide you with the growth you need to maintain your investment value, and the lifestyle you want. Instead, it's a good idea to protect your capital from taxation and inflation by investing some of your money in growth assets, like shares and property as well. Even if you're close to retirement, you still have time for your growth assets to recover from the downturn.

¹Sourced from Australian Bureau of Statistics report Deaths, Australia, 2006 (cat. no. 3302.0).

Source: BT Financial Group

25 year returns of asset classes



Note: accumulated returns based on \$1,000 invested in December 1984.

Source: A&P/ASX 300 Accumulation Index, MSCI World ex-Australia (net dividends) Index in A\$, S&P/ASX 300

Property Index, UBS Composite 0+ years Index, UBS Bank Bill 0+ year.

Past performance is not a reliable indicator of future performance.

The outlook for investment markets

Asset class

Short term prospects

Listed property

Australian real estate investment trusts (A-REITs) have been severely beaten back from overvalued levels, reflecting the sector's high levels of indebtedness and complex financial engineering. Looming debt maturities and falling valuations continue to plague the sector, and further announcements regarding breaches of loan covenants are anticipated. Increased vacancies will also drag earnings down over the course of the economic slowdown. However, much of this bad news is known and has been priced in by the market, and many A-REITs have rallied hard from near capitulation selling in March 2009. Quality A-REITs caught up in this vicious selling now offer good value for patient investors.

Residential property

Residential property has benefited from rising rents and an increase to the First Home Owner Grant, providing some support (distortion) for prices. Once government grants and stamp duty holidays go, this activity may slow as high house prices to disposable income ratios continue to adjust.

Cash

The Reserve Bank of Australia (RBA) slashed interest rates from 7.25 to 3% in a succession of quick moves as the credit crunch took its toll on the local economy. The RBA has indicated that interest rates may now have bottomed, though the timing of future hikes is unclear. In light of an improving economic outlook, investors who had flocked to cash will need to weigh up its relative safety against the prospective yields on offer in riskier asset classes.

Bonds – Australian and international fixed interest

Yields remain attractive on high quality corporate debt, and a degree of spread compression is anticipated when confidence reverts to more normal levels. Until then, investors should closely monitor default rates in the sector. Government bonds also enjoyed good returns as rates were cut across the globe. However, rising yields may be the source of short term pain when the rate cycle turns.

Australian shares

The Australian market has rallied more than 50% off its March lows. While a correction of sorts cannot be ruled out after such a strong bounce, the market has been supported by improving economic conditions and a better than expected reporting season to date, primarily off the back of aggressive cost reductions. However, the share price rally of some companies should be treated with caution, given that the problems of highly leveraged balance sheets have not gone away. On the other hand, opportunistic companies, which have raised additional capital to the tune of \$90 billion in recent months, find themselves better placed. While our banks remain in relatively good shape, attention must be paid to bad loan provisions and the continuation of the challenging operating environment. Dividend cuts across financial shares are indicative of the need to preserve capital. While future earnings guidance is cautious, evidence of earnings stabilisation could provide a positive backdrop for shares for the remainder of 2009, albeit at a more subdued pace.

International shares

The green shoots of recovery have put a fire under global markets at a time when most investors were pondering how much further things could fall. From March lows, equity markets across all the major regions are up in excess of 40%. Recent economic news out of Japan, France and Germany revealed growth in the second quarter and there are indications that the US is also nearing the end of its recession. US equities have completed their latest round of quarterly earnings, with the majority of corporates beating expectations, though it should be noted that profits are down some 30%. Global markets are factoring a robust economic recovery, though it is possible that disappointing data could halt the market's march, along with any withdrawal of expansionary policies. Ultimately, uncertainty around earnings must be addressed for a sustainable rally, and investors should continue to look to companies with strong market positions and that are capable of generating solid cash flows.

Enduring issues for everyone

So you've made a will and taken out life insurance to provide for your family in case your number comes up sooner than expected. But what if instead of dying you became mentally incapacitated? Who could you trust to make financial, medical and lifestyle decisions on your behalf? And how can you make sure they'll have the power to do so unchallenged?

Gemma and Tom, both 32, had been living together in Sydney for just on a year when he suffered a serious brain injury in a car crash. As their defacto arrangement was still relatively new, Gemma and Tom had separate finances at the time of the accident. To make matters worse, Tom's mother Ruby didn't approve of his relationship with Gemma.

Although Tom was a lawyer, he hadn't appointed an enduring power of attorney to handle his financial affairs. That meant neither Gemma nor Ruby were legally able to administer his finances or access his bank account without first formally applying to the NSW Office of Protective Commissioner for permission to do so. Ruby, who had never warmed to Gemma, decided to also lodge an application.

With two parties contesting as to who should be Tom's attorney, this became a protracted process and an added headache and heartache for both Gemma and Ruby during a very traumatic time in both their lives.

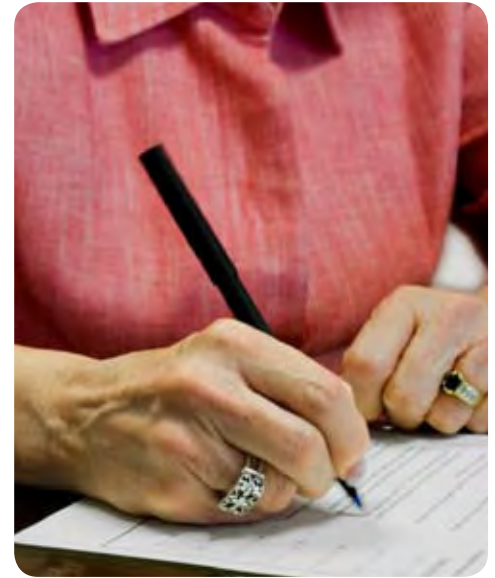
Meanwhile, Gemma struggled to meet Tom's mortgage repayments on her nurse's salary while awaiting the Commissioner's decision.

All this could have been avoided had Tom had the foresight to appoint an enduring power of attorney to handle his affairs in this situation.

An enduring power of attorney is a document whereby one person (the principal) authorises another (the attorney) to act on his or her behalf, generally in relation to financial and property decisions. In some states, this can also extend to medical and lifestyle issues. An enduring power of attorney differs from a general power of attorney in that it doesn't cease to operate if the principal becomes of unsound mind.

An enduring power of attorney can come into effect from the date signed/specified or when a particular event occurs (such as when the principal becomes of unsound mind).

Legislation differs from state to state. Whereas in NSW an enduring power of attorney is not permitted to make decisions in relation to medical treatment, that's not the case in Victoria, South Australia, the ACT and Queensland. In NSW, where a more extensive medical and lifestyle enduring power of attorney is not available, it's important to also appoint an enduring guardian under the Guardianship Act 1987 that can perform these functions in the event of the appointor's incapacity.



Similar provisions exist in other states (except WA) where broader enduring powers of attorney are not available.

A principal can make or revoke an enduring power of attorney at any time provided they have the mental capacity. The easiest way to revoke a power is to tear up all copies. It's also a good idea to send a signed letter to all financial institutions informing them that the relevant power of attorney is revoked and asking for all copies to be posted back.

Your financial planner can assist you to put in place an enduring power of attorney and address your other estate planning needs.

Source: Alena Miles, Technical Analyst, Zurich

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