2007/08 Financial Year Review

PERENNIAL INVESTMENT PARTNERS

History reminds us that investment markets do eventually recover and all that is achieved by the panic selling of assets is to lock in losses and deny investors the opportunity to be positioned for the recovery in asset prices.

Investment markets soured over the year as problems in the US sub prime lending sector morphed into a broader global credit crunch. Developments were not helped by rising food and energy prices, which sapped consumer and business confidence. Share markets, which had risen steadily since the end of the Iraq War in early 2003, peaked towards the end of 2007 and fell thereafter. Financial sector stocks, in particular, fell sharply as US sub prime related losses mounted.

The contagion was not limited to share markets, with global and domestic listed property securities heavily affected by falling real estate prices and higher funding costs. Even defensive assets like global and domestic fixed interest were partly affected as the cost of bank and corporate debt rose.

After a period of very strong returns from investment markets, investors in global and domestic shares and listed property sectors experienced falls in the value of their investments. Returns on defensive assets, like global and domestic fixed interest and cash were positive. Investors in multi sector funds, like balanced funds, benefited from exposure to defensive assets which partly offset the fall in value of growth assets.

Years like this are not unique and are a reminder that investment markets can go down as well as up. As a matter of investment housekeeping, investors should always review their portfolio and stick to well thought-out strategies with appropriate time frames. History reminds us that investment markets do eventually recover and all that is achieved by the panic selling of assets is to lock in losses and deny investors the opportunity to be positioned for the recovery in asset prices.

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SECTOR COMMENTARY

International Shares
Highlights from the 2007-08 financial year

The pace of global growth slowed over the year, largely as a result of a cooling US economy. Other industrialised countries held up better but began showing signs of slowing late in the financial year. Growth rates in emerging economies, like China, also appeared to have moderated over the first half of 2008 but still remain at robust levels. Against this backdrop, returns from the international shares sector were down by 21.3%* in Australian dollar terms for the financial year.

Looking ahead

Forecasts are for the global economy to grow over the next year but at a rate below that experienced over recent years. Higher food and energy prices, and the risks that these will translate to higher inflation, will make it hard for central banks to cut interest rates to boost sluggish economies. Indeed, they may be forced to increase interest rates to fight inflation. The sector faces headwinds but the US economy is expected to gradually recover and this would be positive for sector returns.

Australian shares
Highlights from 2007-08

After several years of very high returns, fuelled by strong gains in the Resources sector, the Australian share market fell 13.7%* over the 2007-08 financial year. Behind the result was a tale of two sectors. The Resources sector, boosted by further gains in commodity prices, rose 27.7%* over the financial year. In contrast, the Industrials sector, which includes the hard hit financials, fell 26.7%*.

Looking ahead

A period of more moderate growth in the Australian economy lies ahead and this is beginning to be factored into the share market. A domestic recession seems highly unlikely given the amount of resource and public sector investment projects in the pipeline. If the outlook did deteriorate significantly, the RBA has plenty of scope to cut cash rates and such a move would be supportive of the share market.

Global property securities
Highlights from 2007-08

Falling US house prices and the negative effects from the US sub prime crisis were the main drivers behind a 22.3%* fall in the global property securities sector returns. UK and continental European property stocks were the hardest hit, with Hong Kong recording the smallest losses for the year.

Looking ahead

Following recent falls, the sector is now priced at levels which offers attractive returns for long-term investors. Whilst global GDP growth is slowing, and the liquidity crisis in the credit markets is lifting the return thresholds, there are opportunities to access good quality property, in markets which are fundamentally sound, where assets are professionally managed by high quality teams.

Australian listed property securities
Highlights from 2007-08

A combination of contagion from the sub prime crisis in the US and rising funding costs saw returns from the sector fall 36.4%. This fall follows gains of 25.9%* for the previous financial year. Historically, Australian property trusts were quite conservatively geared but over recent years they have become more highly geared, making them more vulnerable to changes in funding conditions.

Looking ahead

The recent sell-off does come after several years of strong gains and the sector is now looking "cheap to fair valued". The characteristics of the sector have changed over recent years and investors should be aware that the composition of earnings in most of these vehicles makes their earnings highly susceptible to foreign exchange rates, interest rates, asset values and other factors outside of management control.

International fixed interest
Highlights from 2007-08

Offshore interest rates trended lower as the US Federal Reserve aggressively cut the US cash rate by 3.25% to 2%. Although the spread between government and non government debt securities widened over the year, as credit conditions worsened, the sector still posted very good returns. After returning 5.7%* over the 2006-07 financial year, the sector returned 7.9% over 2007-08 financial year.

Looking ahead

Returns are likely to be lower over the coming year as global central bankers deal with the threat of rising inflation due to higher food and energy prices.

Australian fixed interest
Highlights from 2007-08

The Australian fixed interest sector returned 4.4%* after generating a return of 4.0% the previous year. Yields continued to rise as the economy remained strong enough for the RBA to tighten monetary conditions. Yields on non government debt were also pushed higher by the tightening in global credit conditions experienced over the year. These factors led to minor capital loss in the sector, but higher running yields meant the sector still posted positive returns.

Looking ahead

Running yields are relatively high, particularly for high quality semi government and corporate debt securities. These have scope to fall as global credit markets heal and would, in turn, boost sector returns. Likewise, if markets began to factor in the chance of an RBA easing, should the economy slow as the RBA expect, yields would rally lower and the resultant capital gain would boost sector returns. After returning less than the cash rate over the 2007-08 financial year, the sector is likely to offer returns higher than the cash rate over the year ahead.

Cash
Highlights from 2007-08

Cash deposits returned 7.34%* last financial year. Returns were higher than the previous year due to the RBA lifting the cash rate from 6.25% to 7.25% over worries that high levels of capacity utilisation would jeopardise its ability to keep inflation under control.

Looking ahead

The return on cash is driven by the actions of the RBA. Sector returns are likely to be similar or lower than last year depending on whether the inflation outlook provides the RBA with room to ease monetary conditions in the first half of 2009.

*Benchmarks

Australian equities - S&P/ASX 300 Accumulation Index; S&P/ASX 300 Resources Accumulation Index; S&P/ASX 300 Industrials Accumulation Index

International equities - MSCI World (ex Australia) Accumulation Index – unhedged

Global property securities - FTSE EPRA/NAREIT Global Real Estate Total Return Index (Hedged to $A)

Australian listed property securities - S&P/ASX 200 Property Accumulation Index

Australian fixed interest - UBSA Composite Bond Index (All Maturities)

International fixed interest - Lehman Brothers Global Aggregate Index (Hedged to $A)

Cash - UBSA Bank Bill Index the index by 3% p.a. over rolling three year periods.