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# Investment Manager Outlook

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Country: Australia

Synopsis: Russell's quarterly survey of  
Australian investment managers  
and their views of the market

# About the Investment Manager Outlook

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Welcome to the twenty-eighth edition of Russell's quarterly Australian Investment Manager Outlook, intended to generate a meaningful snapshot of Australian investment manager sentiment.

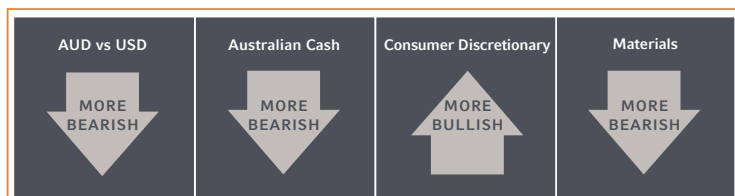
Because globally we conduct over 5,000 meetings with investment managers each year, following their careers and gaining their insights, we have extraordinary access to some of the world's best investment minds. Through the IMO, we bring you their knowledge and opinions so you can make decisions that will benefit you and your investors.

Each quarter, we survey around 40 Australian fund managers to collect their top-line opinions about the direction of the markets, their opinions on which sectors and styles to watch, and trends on the horizon that could affect your investment strategy.

# Summary of key findings

## VOLATILE MARKETS DAMPEN MOODS, BUT HOPE LIES WITH DOMESTIC SHAREMARKET TO DELIVER IN THE NEW YEAR

Exhibit 1A: Biggest shifts - December 2011 Investment Manager Outlook survey



Compared to survey results from September 2011 Investment Manager Outlook survey, net balance basis.

Global and domestic share markets rose over the two months to 30 November 2011<sup>1</sup>, despite the lingering uncertainty caused by Europe's persistent sovereign debt woes. The start of the fourth quarter saw the 'risk off' theme that had characterised investment markets in recent quarters reverse sharply in October, amid hopes of a resolution to the European debt crisis and a modest improvement in US economic data, including stronger employment numbers. However, the rally proved to be short lived as renewed fears about the solvency of Greece and the core European markets of Spain and Italy sparked yet another sell off in November. Also adding to the negative tone in the second half of the period was further political upheaval in Greece and Italy, where both prime ministers agreed to step down and be replaced by interim governments charged with the difficult task of stabilising their respective economies.

The Australian share market rose in line with its global counterparts, with the S&P/ASX 300 Accumulation Index closing the period 3.5% higher on the back of some better-than-expected domestic economic data and the Reserve Bank of Australia's (RBA) decision to lower interest rates. However, like its global counterparts, the gain disguised the weakness seen in share markets in November.

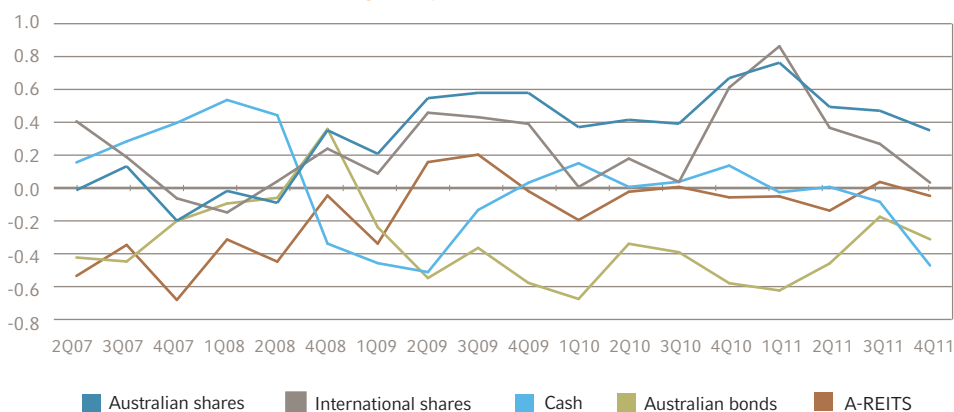
In this latest survey, we profile the way managers have amended their outlook in response to recent market events and where they see the best investment opportunities going forward.

"The start of the fourth quarter saw the 'risk off' theme reverse sharply in October... however, the rally proved to be short lived..."

<sup>1</sup> Due to the earlier-than-usual timing of the Australian Investment Manager Outlook, all commentary and investment returns provided in this report are as at the latest month end available (30 November 2011).

# Summary of key findings (continued)

**Exhibit 2A: Net balance of manager expectations (bullish less bearish)**



## Volatile markets dampen moods

Despite October’s ‘relief’ rally, managers clearly remain cautious about the outlook for investment markets as increasing uncertainty in Europe continues to impact sentiment. Whilst it’s perhaps not unexpected to see that negative sentiment toward growth assets like Australian and international shares increased over the period, what is interesting is that bearish sentiment actually rose across the board, including within the traditionally defensive sectors of domestic cash (61%) and bonds (55%). Meanwhile, the Australian dollar (AUD) made a modest gain against the US dollar (USD), though at current levels around parity, managers maintain their view that the AUD is overvalued and this undoubtedly contributed to the rise in bearish sentiment (54%) toward the currency. Exhibit 2A shows the net shift in overall manager sentiment over the period.

Similar to last quarter, managers remain far more bullish on domestic shares (61%) compared to global shares (45%), with the gap in sentiment widening over the period. Further, the sharp sell off in domestic shares since their April peak means the majority of managers (65%) maintain their view that the local market is undervalued, while 35% believe it to be fairly valued. No managers consider the Australian share market to be overvalued.

**“...the sharp sell off in domestic shares since their April peak means the majority of managers maintain their view that the local market is undervalued...”**

# Commentary & Analysis

## Caution still the overriding theme

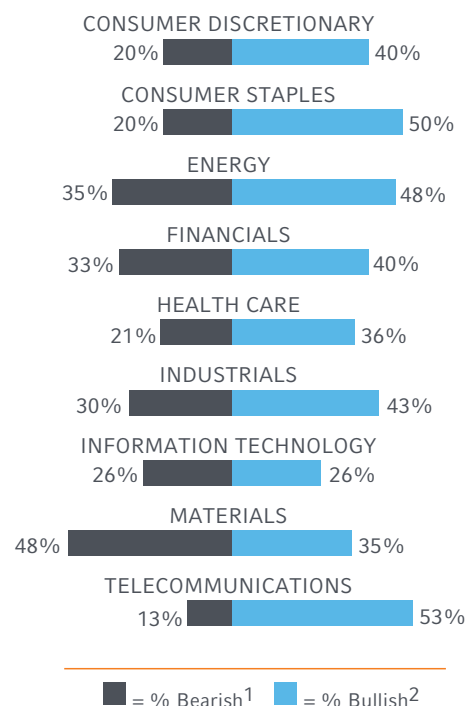
Bearish sentiment toward international shares (42%) continued to rise over the period and is now at a level 14 times greater than it was in the March quarter; when negative sentiment was at an all-time low of just 3.0%. Europe's escalating sovereign debt crisis and the rollercoaster ride that is the US recovery have had a significant impact on global share markets, which have fallen 5.2%<sup>2</sup> so far this year. With no real resolution to Europe's debt woes in sight, managers strongly believe the downside risks to international shares far outweigh any positives.

Cheaper valuations and its relative stability compared to the likes of Europe and the US were arguably behind managers' preference for Australian shares versus their international equivalents, though bearish sentiment did rise slightly from 20% to 27% over the period. Similarly, negative sentiment toward small caps (40%) edged higher, presumably because managers prefer the relative stability of larger cap stocks amid the current market uncertainty. Small resources outperformed small industrials over the period, though managers appear less confident of both on account of the weaker growth outlook.

In November, the RBA started to cut the official cash rate by 0.25% as the downside risks to the global economy increased on the back of Europe's worsening debt crisis. The rate cut – the central bank's first since April 2009, along with the subsequent cut in early December, have reduced the attractiveness of cash and this was highlighted by the sharp rise in bearish sentiment toward the asset class (from 37% to 61%). That said, domestic rates (now at 4.25%) remain much higher than developed counterparts offshore.

The strong rally in Australian bonds in recent quarters – the result of the deteriorating debt situation in Europe – has seen yields fall to historically low levels, making domestic bonds relatively expensive compared to other asset classes. As a result, the bullish sentiment that had characterised the sector for much of the year turned bearish over the period, with 55% of managers viewing the sector less favourably. However, it is worth noting that Australian bonds continue to offer better value than their global counterparts, including US Treasuries and German bunds, based on current yields.

**Exhibit 2B:** Manager expectations by sector



Note: Bearish = percent of managers responding with 1–3 on a scale of 1–7. Bullish = percent of managers responding with 5–7 on a scale of 1–7. Scores for neutral (4) are not included. Rounding errors may occur.

<sup>2</sup> International shares measured by the Russell Developed Large Cap Index (in AUD terms).

# Commentary & Analysis (continued)

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Despite the sector's relatively defensive nature, speculation of further interest rate cuts by the RBA and strong investor interest from overseas, Australian real estate investment trusts lost favour with managers over the period, with bearish sentiment increasing from 18% to 32%.

Sentiment toward the AUD also turned more bearish, rising from 38% to 54%. Despite the AUD trading below parity for much of the period, it's clear that managers still consider the local currency to be significantly overvalued at current levels. Russell shares this view, noting the current valuation is well above the long-term purchasing power parity estimate of USD0.68.

## Australian shares: Sector sentiment breakdown

Bullish sentiment toward the consumer-related sectors increased significantly over the period. Consumer staples (50%) gained favour due to their defensive characteristics in the face of rising market uncertainty while the RBA's recent rate cuts and hopes of positive Christmas-related spending may have contributed to the rise in managers' preference for consumer discretionary stocks (40%). Despite global growth concerns, sentiment towards the energy sector remained relatively high at 48%.

Meanwhile, bearish sentiment toward the materials sector (48%) increased for a fourth consecutive quarter amid concerns that Europe's escalating sovereign debt crisis and weaker global growth will further impact falls in commodity prices. Increasing signs of an economic slowdown in China – our largest trading partner – is also affecting managers' view of the sector. In fact, the last time managers were this bearish on materials was during the global financial crisis.

Similarly, managers were also more cautious about Industrials, with bearish sentiment toward the sector rising to 30% from 24% last quarter. The result suggests that despite the recent fall in the AUD (it traded at USD1.1061 in August) and expectations of further RBA interest rate cuts, fears of slower growth both in Australia and globally are driving concerns for the sector.

## How will the Australian share market perform in 2012?

So far this year the Australian share market has fallen 9.7%, driven largely by the effects of Europe's persistent sovereign debt woes and increasing fears that the global economy is headed for recession. Closer to home, the local market was also impacted by the uncertainty surrounding the Federal Government's carbon tax, a slowing domestic economy and the threat of a potential 'hard landing' in China.

In this latest survey, we asked managers for their view on how the Australian share market will perform in 2012. The results, summarised in Exhibit 3A, reveal that the majority of managers (46%) believe the local market will rise by 10% or more next year. By contrast, only 2% of those surveyed believe the market will go the other way and close the year significantly lower.

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**"...the majority of managers believe the local market will rise by 10% or more next year."**

## Commentary & Analysis (continued)

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Amongst those managers who believe the market will rise in 2012, there were several key themes to emerge. The majority of managers believe that after several quarters of losses, Australian shares are now very attractive relative to other asset classes, particularly domestic bonds. Further, Australian companies are likely to benefit from stronger balance sheets, expectations of additional interest rate cuts by the RBA and a relatively low inflation environment. That said, managers agree that market volatility will remain at elevated levels throughout 2012<sup>3</sup>.

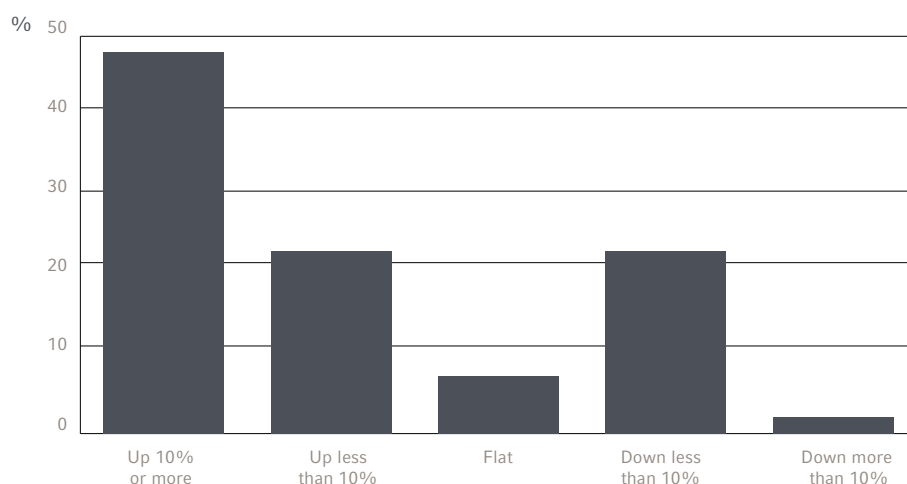
By contrast, further deterioration in Europe's sovereign debt crisis is seen as the biggest threat to Australian shares, particularly amongst those managers who expect the domestic market to fall next year. Europe's persistent debt woes – and a lack of any real action by officials to resolve them – have the potential to drag the region into recession next year. Any contraction in the euro-zone would obviously have a significant impact on growth elsewhere, including China, and also drive commodity prices sharply lower.

Overall though, managers appear more bullish than bearish on the outlook for Australian shares, with more than two-thirds of those surveyed expecting the market to rise over the next 12 months.

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**“...managers agree that market volatility will remain at elevated levels throughout 2012.”**

**Exhibit 3A: Manager expectations for S&P/ASX 300 for 12 months ending 31 December 2012**



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<sup>3</sup> This quarter's U.S. Investment Manager Outlook asked managers whether they expect equity market volatility levels to continue to remain elevated in 2012. A summary of the survey results can be in the Appendix.

RESULTS

# Valuation of the Australian share market

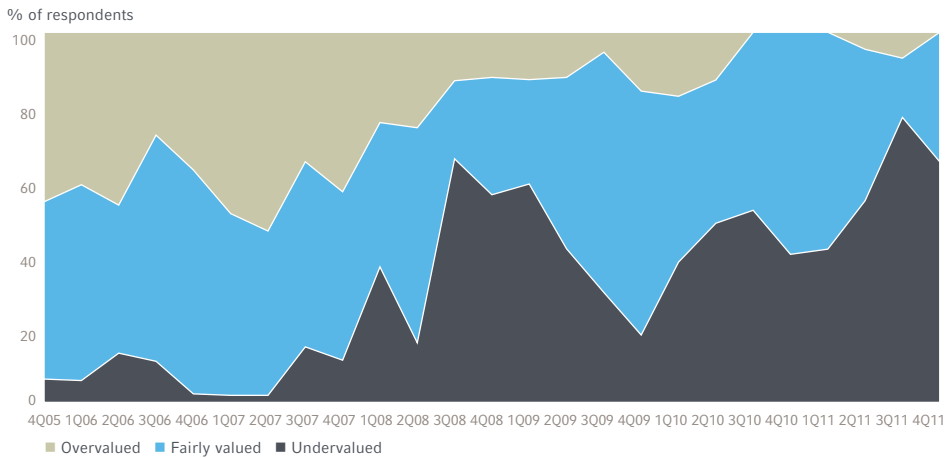
**Question 1:**

Which of these general valuation conditions best describes the current Australian share market?

**Key findings:**

- › The sharp sell off since their April peak saw the majority of managers (65%) maintaining their view that the Australian share market is undervalued.
- › The remainder of managers surveyed (35%) believed the market was fairly valued with no managers considering the market overvalued.

**Exhibit 4A: Shifts in market valuation**



**“Australian equities remain extremely attractive, trading almost at record valuations as investors remain burnt... and European debt problems dominate the headlines.”**

PHILIP KING  
Regal Funds Management

RESULTS

# Asset class expectations

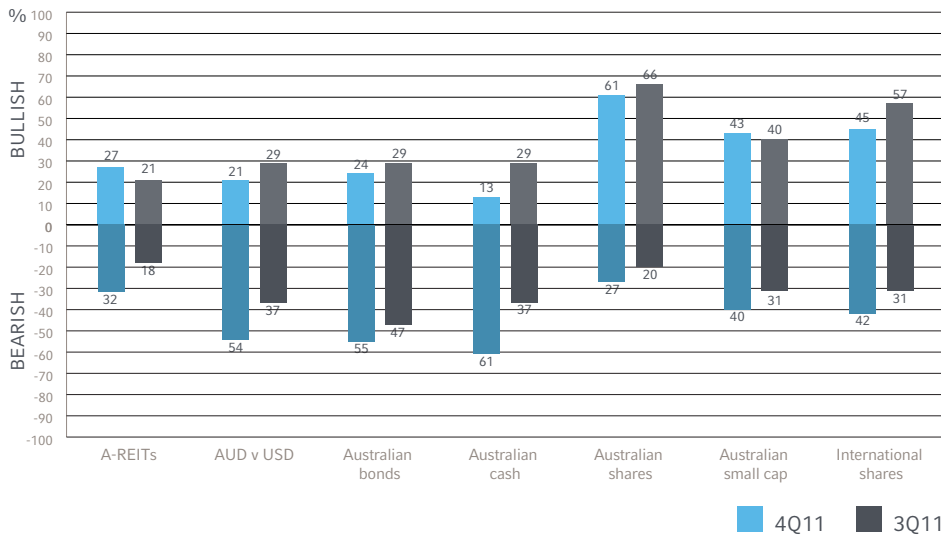
**Question 2:**

What are your expectations for the performance of the following asset classes over the next 12 months?

**Key findings:**

- › The market’s risk aversion is reflected in the general bearish sentiment across bonds, cash, shares and the Australian dollar.
- › Comparing growth vs defensive stocks, managers continue to prefer shares over bonds and cash. Further, managers continue to favour Australian over international shares as European concerns spread to Italy & Spain.

**Exhibit 5A: Manager expectations – asset classes**



**“European policymakers will remain behind the curve and we foresee the European crisis getting considerably worse before it eventually gets better.”**

NICK MAROUTSOS  
Kapstream Capital

RESULTS

# Sector expectations

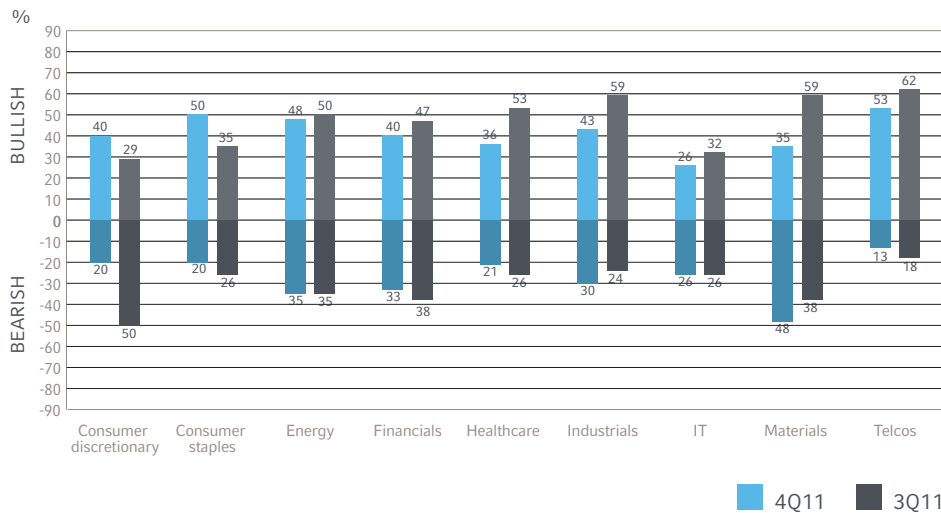
**Question 3:**

What are your expectations for the performance of the following sectors over the next 12 months?

**Key findings:**

- › Bearish sentiment toward the materials sector continued the trend from last quarter, with another 10% of managers shying away from the sector, again reflective of concerns for global growth and possible slowdown in China.
- › The outlook for Consumer Discretionary improved significantly throughout the quarter, with 40% of all managers surveyed now bullish on the sector, up from 29% last quarter. At the same time, the number of bearish managers on the sector also fell from 30% (from 50% last quarter to only 20% currently), reflecting a more conducive environment for consumers with recent interest rate cuts.

**Exhibit 5B: Manager expectations – Australian sectors**



**“With the market increasingly following macro factors, there has been little differentiation in performance between quality companies and the rest, and we think this will reverse as we approach the February reporting season.”**

**NEIL BOYD-CLARK**  
 Arnhem Investment Management

## RESULTS

# Sharemarket expectations

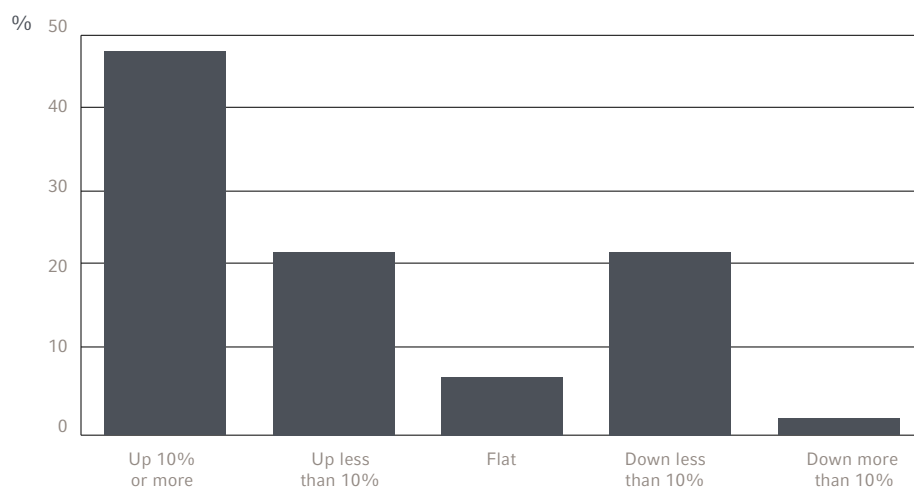
### Question 4:

What are your expectations for the performance of the S&P/ASX 300 for the 12 months ending 31 December 2012?

### Key findings:

- › The majority of managers (68%) are positive about the outlook for the Australian sharemarket and expect the S&P/ASX 300 to be higher by this time next year.
- › In particular, nearly half of the managers surveyed (46%) expected the local market to rise by 10% or more next year.

### Exhibit 6A: Expectations for the performance of the S&P/ASX 300 for the 12 months ending December 2012



<sup>1</sup> This quarter's U.S. Investment Manager Outlook asked managers whether they expect equity market volatility levels to continue to remain elevated in 2012. A summary of the survey results can be in the Appendix overleaf.

**“Valuations remain attractive with robust corporate profitability, supported by strong balance sheets, risk averse management behaviour and easier monetary policy.”**

MIKE JENNEKE  
Sigma Funds Management

# Highlights from Russell's U.S. IMO survey Q4 2011

Russell Investments also survey U.S. investment managers on their market insights. In particular, this quarter's U.S. Investment Manager Outlook asked managers whether they expect equity market volatility levels to remain elevated in 2012. Highlights of the survey findings are summarised below.

## Summary of Key Findings

A wide majority of surveyed managers say they expect higher volatility levels, such as those seen in 2011, to continue during 2012.

### Key findings:

- › A large majority, 70 percent of managers, say they expect high market volatility to continue during 2012. Of these managers, 63 percent say that despite expected market volatility they like their current investment positioning and do not plan to make portfolio changes based on volatility expectations. Another 19 percent of managers expecting continued volatility cited a variety of reasons for why they will make changes to their portfolios. Generally, those reasons involved allocating assets to capitalise on the volatility or to minimise associated risks.
- › Dissenting managers, 30 percent of those surveyed, believe market volatility will be tempered during 2012. They gave varying reasons for their opinions, with most involving stabilisation of the European debt crisis. More clarity surrounding U.S. economic concerns was also cited as reasons to expect less volatility during 2012. Others believe volatility will be tempered in 2012 only because it was so high in 2011 and they don't expect such extremes to continue.

Exhibit 7A: Do you expect similar volatility levels to continue through 2012?

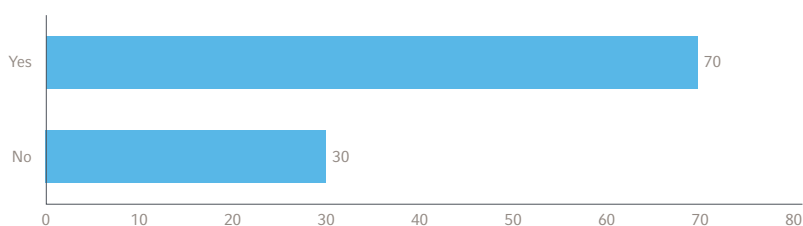
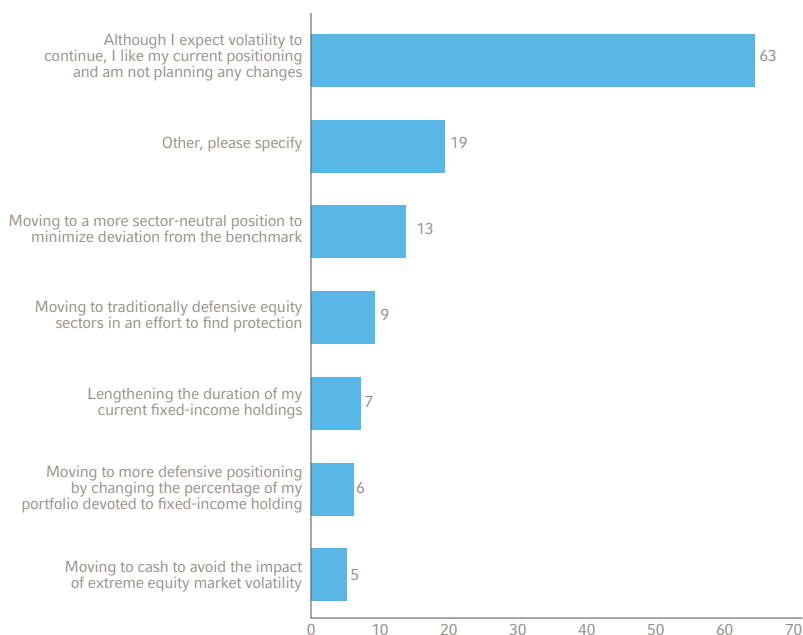


Exhibit 7B: (IF YES) What changes are you making to your portfolio as a result of your volatility outlook? (Please select all that apply)?



# Methodology and about Russell Investments

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## Methodology

Russell Investments conducted the Australian Investment Manager Outlook between 14 to 27 November<sup>1</sup>. The survey was sent to investment managers with a variety of investment focuses but is primarily made up of Australian large-cap, multi-cap and small-cap share managers, researched by Russell. Having a financial relationship with Russell was not part of the criteria for being included in the survey. In total, 41 investment management firms from Australia participated in the survey.

The large majority of individual respondents to the Investment Manager Outlook have senior-level investment decision responsibilities and are often portfolio managers or CIOs. Other participants included investment strategists, select research analysts, and others. The manager research that Russell conducts for investment purposes is done entirely independently of the Investment Manager Outlook, and responses to the survey are on a purely voluntary basis.

## About Russell Investments

Russell Investments is a global investment management company that believes investors of all sizes can benefit from access to the world's leading money managers. To that end, we research, identify and select best-of-breed investment managers from around the world. We put those managers to work for some of the world's largest investors, financial advisers and individuals saving for retirement.

We provide sophisticated investment solutions including investment and superannuation funds, pensions, institutional asset management and implementation services, as well as our global shares indices.

Everything we do is guided by our desire to improve financial security for people. For more information about how we help investors around the world achieve their goals, visit us at [www.russell.com.au](http://www.russell.com.au).

Founded in 1936, Russell Investments is a subsidiary of Northwestern Mutual and is headquartered in Tacoma, Washington, with additional offices in New York, Toronto, London, Paris, Singapore, Sydney, Melbourne, Auckland, and Tokyo.

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<sup>1</sup> The US Investment Manager Outlook, summarised in the Appendix, was conducted between November 1 and November 11, 2011.

# Asset class definitions

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## Broadmarket Australian shares

Australian shares are a growth asset involving the purchase of ownership interests – and the rights to profit and voting that this implies – in a company listed on the ASX. Shares may be purchased from sectors including financial, materials, industrial and energy.

The risks faced by Australian shares investments include liquidity risk, market risk and company-specific risk; the value of investments is subject to changes to management, product distribution, investor confidence, internal operations and the company's business environment. The All Ordinaries Index, which represents around 99% of the Australian shares market, may be considered in assessing the risk profile of Australian equities.

## Small cap Australian shares

A subset of Australian shares, small cap generally refers to companies with relatively small market capitalisation – below around \$2 billion. Small cap shares have some advantages over large cap shares including faster growth rates, faster response to changing market conditions and less agency concerns between management and shareholders. These investments provide the potential for strong growth over the longer term.

Small cap shares are inherently much more risky than large cap. Primary risks faced by small cap investments include rising interest rate risk, falling exchange rate risk and low liquidity. The ASX Small Ordinaries Index could be considered in assessing the risk profile of small cap Australian shares.

## Australian real estate investment trusts (A-REITs)

A-REITs are collectively owned growth assets that invest in a portfolio of property. There are more than 45 A-REITs on the Australian Stock Exchange, primarily run by property management groups such as Lend Lease, Westfield and Deutsche Asset Management. A-REITs are a liquid, diversified investment providing an attractive yield in the form of annual or semi-annual dividends with some capital growth.

Risks faced by A-REITs include interest rate and market risk, security risk associated with property investment and distribution risk as dividends are not guaranteed by the A-REIT or ASX. The S&P/ASX 300 A-REIT Accumulation Index could be considered in assessing the risk profile of Australian property trusts.

## Australian bonds

Australian bonds (or fixed interest) are a defensive asset providing debt capital to organisations in return for coupon payments and return of capital at expiry. Australian bonds may invest in a variety of sectors including government, corporate, international, semi-government and asset-backed. The sector chosen will determine, in part, the riskiness of the bond.

In general there is a negative relationship between interest rates and the value of bonds. The primary risks associated with Australian bonds include interest rate risk, inflation risk and credit risk. The UBS Australian Composite Bond Index could be considered in assessing the risk profile of Australian bonds.

## Asset class definitions (continued)

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### Australian cash

Australian cash is a defensive, low-risk asset typically involving bank backed or short term securities. Cash provides diversification and liquidity benefits to a portfolio; however it generally provides lower investment returns than investments such as fixed interest, property or shares, and interest on cash investments has not kept pace with inflation in the past.

Aside from inflation risk, cash also faces interest rate risk as the prices of cash securities can fall as interest rates rise. The UBS Australian Bank Bill Index could be considered in assessing the risk profile of Australian cash.

### International shares

International shares are a growth asset involving share investments in regions such as North America, Europe, Japan and UK. International shares have historically produced higher long-term returns than lower risk investments; however they tend to be relatively less liquid and more volatile than domestic shares.

International equities entail different risks than those typically associated with domestic shares, including currency fluctuations, political and economic instability, accounting changes and foreign taxation. The Russell Developed Large Cap – Net Index could be considered in assessing the risk profile of International shares.

# General disclosures

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**Performance quoted represents past performance and should not be viewed as a representation of future results.**

1) We define bearish as...on balance, an organisation's or individual's predominant view based on a belief that general market conditions for the period in question will be negative, and relative valuations of securities in general will trend downward. This view should not be considered investment advice nor does it apply to any specific security.

2) We define bullish as...on balance, an organisation's or individual's predominant view based on a belief that overall market conditions for the period in question will be positive, and relative valuations of securities in general will trend upward. This view should not be considered investment advice nor does it apply to any specific security.

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