

The View

A quarterly publication from QIC - October 2010

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Message from Doug



Following two weeks of uncertainty, and many more weeks of campaigning, the Australian Labor Party (ALP) was finally named as Australia's minority government, scraping in by the smallest of margins. However, much uncertainty still remains, particularly regarding the government's ability to effectively govern without a clear mandate.

While the outcome of the federal election is important for Australia, I don't believe that it will have a significant impact on our economic environment. Some policy issues need to be settled of course, particularly policies regarding the ALP's mining tax and its National Broadband Network, but who runs our country will not have much of a macro impact. Rather, our economic fate lies largely in the hands of the US consumer. As I have said before, the global financial crisis was a crisis in confidence. US consumers make up roughly 20 per cent of world consumption. When they choose to stop spending the global economy grinds to a halt. When they start spending again, the world economy bounces back, as it is currently doing.

Of more concern, in my view, is the overall policy development process, not only in Australia but globally. It appears that the need to win the majority vote has overridden the need for good policy

development and implementation. Around the world, voters are uncertain with new minority governments popping up in the UK, Australia, the Netherlands. The outcome of the looming US mid-term elections will be interesting. The fact that there was little difference between the two major parties in the recent Australian election compounded voter uncertainty, and the minority government will likely further constrain Australia's policy development process. You can find out more about the possible impacts of a minority government on our economy and markets on page 3.

As a result of the recent Ripoll, Henry and Cooper reviews, the federal government now has a significant number of recommendations regarding the superannuation and investment industry to consider. However, as history has shown, reforms from government reviews take time to implement, and in fact are often implemented not by the government that initiated the review, but by its opposition - for example, the Asprey report on taxation (Whitlam government), the Campbell report on financial deregulation (Fraser government) and the Wallis Inquiry into the financial system (Hawke/Keating government). This process is likely to prove even more challenging now given the minority government.

The industry itself also has the task of working through these recommendations, including the 177 recommendations from

the Cooper Review. While the scale of this task is daunting, it is important that we remain focused on the big picture, which is providing better retirement outcomes for members. With this goal in mind, I believe many of these recommendations will be adopted voluntarily by the industry, rather than being mandated, as we have recently seen with the progressive move from commissions to a fee-for-service model.

For QIC, the recommendations affirm our continued focus on liquidity management and after-tax/after-fees investment outcomes. They also affirm our focus on product design, particularly in the area of lifecycle strategies. Super funds are very focused on default option design and post-retirement products, with this focus further sharpened by the Cooper Review's MySuper proposal, and our Lifecycle Strategies team is well progressed in developing solutions that will help them in this regard.

Funds are also reassessing their approach to asset allocation. Following the turmoil of the past couple of years, there is growing interest in true beta diversification and the effective implementation of investment policies, both of which are areas that QIC has proven capabilities in.

In terms of the general economic environment, inflation remains a significant risk in the medium term. On one hand, there are concerns that a

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slow recovery in developed economies will significantly reduce the risk of global inflation. On the other hand, inflation is rampant in developing economies and could well be exported to developed economies. There is also significant uncertainty about whether central banks can successfully unwind the extraordinary measures taken during the height of the global financial crisis before higher inflation expectations take hold.

For many years, QIC has provided inflation protection solutions for our clients, and we also played a key role in developing the inflation swap market in Australia. Now, our Global Fixed Interest boutique has developed a dedicated inflation product, the QIC GFI Inflation Plus Fund, which uses an active management approach to generate excess returns over Australian CPI, with significantly less volatility than traditional inflation-linked bond portfolios. You can find out more about this product, which is the first of its kind in Australia, in the article below.

I hope you enjoy this latest edition of The View. As usual, if you have any feedback, questions or challenges for me or the QIC team, please send them to me directly at d.mctaggart@qic.com.



Doug McTaggart
Chief Executive

Is your inflation protection effective in all market conditions?

The dangers of high inflation and its detrimental impact on investment returns are generally accepted as a key risk for investors. While the current lacklustre recovery in developed economies is likely to push short-term inflation lower, there remains significant uncertainty in the medium to longer-term inflation outlook. Sharp and unanticipated rises in inflation can significantly reduce investment returns, yet traditional approaches to inflation protection have a number of drawbacks.

To address this, QIC Global Fixed Interest (GFI) has launched a new solution that uses a dynamic approach to protect against the effects of inflation. The QIC GFI Inflation Plus Fund is a pooled investment vehicle that actively manages exposures to interest rates and inflation to suit the prevailing risk environment. The fund's target return is CPI plus 4% per annum and it is managed to achieve the objective rather than to reflect a benchmark. Portfolio positions are continually refined to reflect current market conditions and to take advantage of opportunities as they arise. By using this approach, the fund aims to deliver solid inflation plus returns with significantly less volatility than traditional inflation protection strategies.



Susan Buckley, Managing Director of GFI, said the fund was developed to overcome the limitations associated with the conventional approach to inflation protection.

'Traditionally, fixed interest investors have favoured inflation-linked bonds (ILBs) as a means of protecting their portfolio against the effects of inflation. However, ILBs have a history of underperforming in extreme market conditions, which is when the fund most needs the benefit of diversification.'

'The other drawback to this approach is that investment outcomes are often driven by the composition of the ILB benchmarks rather than the client's specific investment objectives. In particular, this can result in a high exposure to interest rate and credit risk, and, when passively managed using the traditional benchmark approach, these risks remain unmanaged.'

The QIC GFI Inflation Plus Fund uses a dynamic investment process that focuses on the expected risk environment, and manages interest rate and inflation risks separately. The fund invests in a range of securities to maintain a high degree of liquidity and provide effective diversification benefits. By choosing this approach, fund

trustees can have greater confidence that their inflation protection strategies will meet their investment objectives.



Kent Wilkes, GFI's Senior Inflation Manager, said 'We have developed simulations to demonstrate the effectiveness of our

inflation management approach relative to traditional inflation-linked bond benchmark portfolio design. These simulations suggest a CPI plus 4% target is achievable with significantly less volatility than the traditional approach, which is important for investors seeking to generate consistent real rates of return.'

'The inflation outlook over the medium and long term remains uncertain, but current pricing in inflation markets provides ideal conditions for funds to protect their portfolio now from potentially damaging inflation spikes.'

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

Implications of a minority government on markets and the economy

With the Australian Labor Party (ALP) scraping in as our minority government by the smallest of margins, the focus has now turned to how a minority government will work and the implications it will have, particularly on policy development. In the following Q&A, our Economics & Research team looks at how a minority government might impact our economy, financial markets and policy development process.

What effect will a minority government have on policy development?

With no clear mandate, the ALP will have limited ability to implement dramatic economic reforms. Combined with the independent members' insistence on parliamentary reform, we can also expect extensive public debate before the government adopts any contentious policy initiatives. The agreement between Tony Windsor, Rob Oakeshott and the ALP included a commitment to establish a Climate Change Committee and convene a public forum of experts to discuss the recommendations of the Henry Tax review. This need for the ALP to gain public and independent MP support will constrain Australia's policy development process.

Will having a minority government have a major impact on the economy?

Arguably, the largest short-term impact a government can have on the economy is through fiscal policy. In terms of fiscal policy, there is a general consensus among the political parties that the budget must

return to surplus by 2012/13. Consequently, a minority government is unlikely to have a significant impact on the national economy in the short run.

However, there will be regional and sectoral implications. Regional Australia has been a big winner in the election thanks to the demands of the independents, with fair and equitable access to the National Broadband Network a key issue in securing their support. Significant climate change policies and tax reform are also more likely under the minority ALP government, although the independents are yet to be convinced of the proposed mineral resource rent tax (MRRT), so further concessions on the resource rent tax are still possible.

What's the impact for financial markets?

There was only a limited impact on financial markets after the election result in August. This is not surprising given the lack of significant policy difference between the two major parties.

Looking ahead, financial markets will be sensitive to the ALP's ability to successfully achieve its policies, particularly its commitment to return the budget to surplus by 2012/13. The limitations on policy development outlined above will reduce the likelihood of further surprises, such as the surprise Resource Super Profit Tax (RSPT) announced in May.

Most market commentators identify the introduction of the MRRT as having a material impact on the equity valuations of mining companies, albeit a more benign impact than the original RSPT. Estimates from equity analysts indicate that the MRRT has reduced Rio Tinto and BHP's net present value (NPV) by around 2% (compared to around 10% with the RSPT), and the coal miners' NPV by around 7% (compared to 15% with the RSPT). Any further change in the design of the MRRT stemming from the Argus Review, or any change required to obtain independent MP support, will affect the valuations of resource companies.



Matthew Peter
Chief Economist

Financial market snapshot

Key Market Indicators (as at 30 September 2010)	FYTD	1 Year	3 Year	5 Year	10 Year
Australian Shares	8.0%	0.6%	-7.2%	4.2%	7.7%
International Shares (Unhedged)	-0.5%	-1.2%	-10.6%	-3.2%	-5.0%
International Shares (Hedged)	10.7%	10.5%	-7.3%	1.4%	0.9%
Australian Bonds	1.3%	7.3%	7.6%	6.2%	6.4%
International Bonds (Unhedged)	-5.5%	-3.8%	4.5%	1.9%	0.9%
International Bonds (Hedged)	3.4%	10.1%	9.6%	7.6%	8.1%
Direct Property (Australia)	2.0%	8.6%	-1.0%	6.1%	8.2%
Listed Property (Australia)	3.8%	-4.1%	-24.2%	-8.1%	3.1%
Inflation (CPI)	-	3.1%	3.0%	3.0%	3.2%

QIC strengthens Global Fixed Interest team

QIC Global Fixed Interest (GFI) has strengthened its credit investment capabilities by appointing Philip Miall as Head of Investment Grade Credit. With GFI's client base expanding domestically and globally, Philip joins the GFI Credit team to undertake investment grade credit research and add value to credit strategies for QIC clients' portfolios.

QIC GFI's Managing Director Susan Buckley said 'Philip has a very strong background in fundamental credit research and portfolio management, and has demonstrated his ability to form high conviction strategies. Philip also brings a track record of working closely with clients to create and adapt solutions that meet their specific objectives.'

Philip was recruited following a global search, and joins QIC from UBS Global Asset Management where he was Head of Credit Research, Asia Pacific.

Economic and market snapshot

Recent months have proved to be a turbulent period for global financial markets, as investors responded to the threat of a sharp slowdown in US and Chinese growth, a return to quantitative easing by the US Federal Reserve and uncertainty over the direction of fiscal policy by the Obama administration.

Ongoing weakness in the US labour market has been negatively impacting market sentiment. With no signs of stability in the US labour market, the fear is that growth in US consumer spending, which accounts for around 70 per cent of US gross domestic product (GDP), will fall and possibly contract in the face of weak income growth and declining consumer sentiment. Although August non-farm payroll data was slightly stronger than

market expectations, the US labour market remains weak, with the unemployment rate increasing to 9.6 per cent over August from 9.5 per cent in July.

Our view is that US employment should continue to gradually improve over the remainder of the year and the US economy will avoid a double-dip recession. We also believe the negative sentiment currently surrounding the US labour market is overblown. In comparison with previous economic downturns, the recovery in the labour market from the trough of the current recession is no slower (and in fact a little quicker) than the speed of labour market recovery during the US recessions of 2001 and 1991. It is normal that the pick-up in employment lags the pick-up in economic growth.

Meanwhile, the Australian economy continues to be among the strongest of the developed nations, with real GDP expanding by an above trend 1.2 per cent in the June quarter. Underpinning the outlook for the Australian economy is the nation's surging terms of trade, with the rise in coal and iron ore prices generating strong profit growth for mining companies. The labour market is reflecting strong growth in economic activity, as recent data showed the unemployment rate dipping to 5.1 per cent. Tight labour markets and rising capacity utilisation are generating conditions for a rise in the rate of inflation, and we expect the Reserve Bank to recommence rate hikes before year end.

QIC Forecast	Australia			US			Europe		
	Current	Dec-10	Jun-11	Current	Dec-10	Jun-11	Current	Dec-10	Jun-11
Interest rates	4.50%	4.75%	5.50%	0-0.25%	0-0.25%	0-0.25%	1.00%	1.00%	1.00%
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Economic growth	1.2%	3.4%	3.8%	-2.6%	2.6%	2.6%	-4.0%	1.5%	1.6%



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