# Russell Investment Manager Outlook

Quarterly survey of Australian investment managers and their views of the market

Commentary by
Peter Gunning, Chief Investment Officer, Asia-Pacific

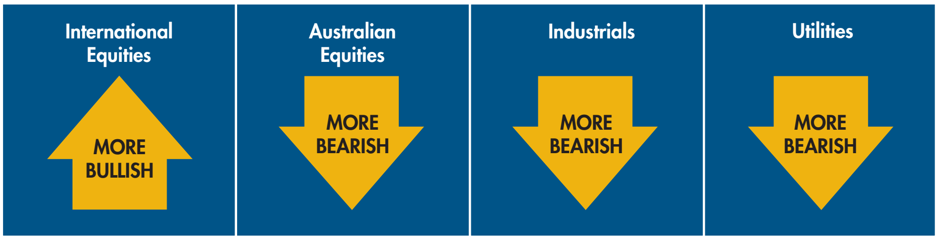
**DECEMBER 2005**

GLOBAL LEADERS IN MULTI-MANAGER INVESTING

Russell

# Survey Goals and Summary of Key Findings

**Biggest Shifts—**December 2005 Investment Manager Survey*




* Compared to survey results from September 2005 Manager Outlook Survey

## Summary of Key Findings

Bullish sentiment towards international equities continues to gain momentum with Australian investment managers expecting international equities to outperform listed property trusts, Australian equities and bonds over 2006.

Two thirds of the 48 managers surveyed now have a bullish outlook for international equities over the next 12 months, up from 51% in September. Only 7% of managers are bearish, compared with 17% in September and 28% in June.

Managers remain divided (44% bearish / 17% neutral / 40% bullish) over the outlook for Australian equities in 2006. Opinion has polarised since last quarter when sentiment was more evenly divided (33% bearish / 31% neutral / 37% bullish).

Attitudes towards Australian equity valuations are virtually unchanged from last quarter with 48% surveyed respondents believing the Australian equity market is 'fairly valued' at current levels while 46% of managers consider the market 'overvalued'. Only 6% of managers regard the Australian equity market as 'undervalued' on current valuations. Those managers who find the market expensive outnumber those who find it undervalued by almost 8-1.

The majority of managers have a benign outlook for cash rates over the next twelve months with 68% of managers neutral on the outlook for cash returns during 2006.

Bearish sentiment to small capitalisation stocks and Australian bonds continues, with 56% and 53% of managers negatively disposed to those segments of the market.

Sentiment to listed property trusts remains the most negative of all asset classes surveyed with 62% of managers bearish, compared to 55% bearish last quarter.

Managers sentiment to the $A vs US dollar has fluctuated significantly with 38% of managers now bearish on the $A/$US cross and 23% bullish compared with 29% bearish and 48% bullish last quarter.

Among sectors, managers are favourably disposed to energy, materials and healthcare and continue to eschew the telecommunication and consumer discretionary sectors. Compared with last quarter, the overall level of positive sentiment for the various sectors weakened across the board.

Finally, managers nominated corporate earnings, interest rates, and oil/energy prices as having the most significant impact on investment markets over 2006.

FUTURE RELEASE DATES

Wednesday, 29th March 2006

Wednesday, 28th June 2006

Wednesday, 27th September 2006

Wednesday, 20th December 2006

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### About Russell's Australian *Investment Manager Outlook*

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

As consultants to more than A$3.2 trillion in assets worldwide, and the only firm that monitors more than 3,800 investment management companies, Russell Investment Group has extraordinary access to senior-level investment decision-makers. Prior to the end of each quarter, Russell surveys a representative sample of those decision-makers to collect their top-line opinions about the direction of the markets, sectors/styles to watch, and trends on the horizon that could impact investment strategy. The result of this survey is the Russell Investment Manager Outlook.

Three of the four questions posed to investment managers will be repeated each quarter, so that results can be measured over time. The poll also includes one topical question that changes each quarter. In addition to providing quantitative results, Russell reviews the data collected each quarter, and provides a qualitative analysis from a senior investment strategist (see page 2).

Russell Investment Manager Outlook is completed and distributed at the end of each quarter (see anticipated future release dates to the left). This report includes responses from investment managers with a variety of investment focuses but is primarily made up from Australian large-cap, multi-cap and small-cap equity managers.

*The manager research that Russell conducts for investment purposes is done entirely independent of Russell Investment Manager Outlook, and responses to the survey are on a purely voluntary basis.*

# Commentary & Analysis

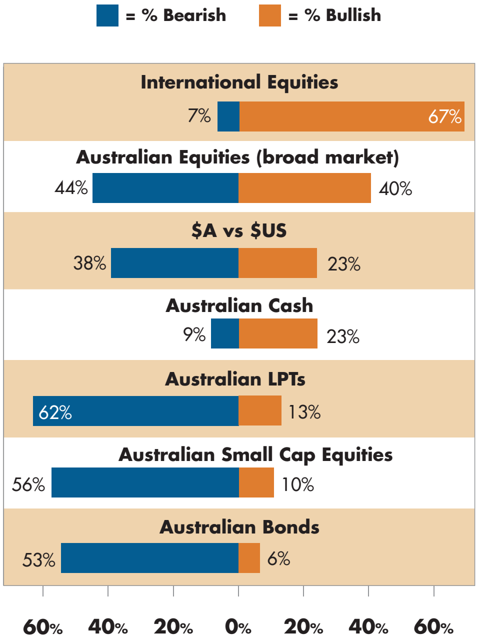
**By Peter Gunning**
Chief Investment Officer, Asia-Pacific
Russell Investment Group

## 2006.
## The Year of International Equities

With the Australian equity market likely to register an annualised return of 20% pa over the past three years to the end of December 2005, compared with a 6% pa return for international shares, many Australian investors have benefited from a classic "home market" bias to Australian shares. However, bullish sentiment towards international equities continues to build momentum with two thirds of Australian investment managers now bullish on the outlook for international shares over 2006. This is by far the strongest level of positive sentiment reported for any asset class in the December quarter. On the flipside less than 10% of managers have a negative outlook for international equities over 2006. Coincidentally, Russell's US based Investment Manager Outlook supports Australian managers' positive sentiment to offshore equity markets with the level of bullishness of US managers directed to their home market increasing despite the US economy weathering a series of unpredictable shocks such as hurricanes Katrina and Rita and continuing interest rate increases. If the pundits are correct, 2006 will be the first calendar year since 1999 that international equities outperform domestic equities.

While managers remain divided over the outlook for Australian equities over 2006 they have become more polarised in their views with 44% bearish and 40% bullish. There is greater consensus on present market valuation with 48% managers believing the equity market is 'fairly valued', 46% 'overvalued' and only 6% regarding the market as 'undervalued' at current levels. Interestingly this more sanguine view of current valuations is reaffirmed in the managers' sector outlook where the level of positive sentiment to every

**Manager Expectations by Asset 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. See detailed charts on the following pages.

# Commentary & Analysis (continued)

sector has decreased from the September quarter.

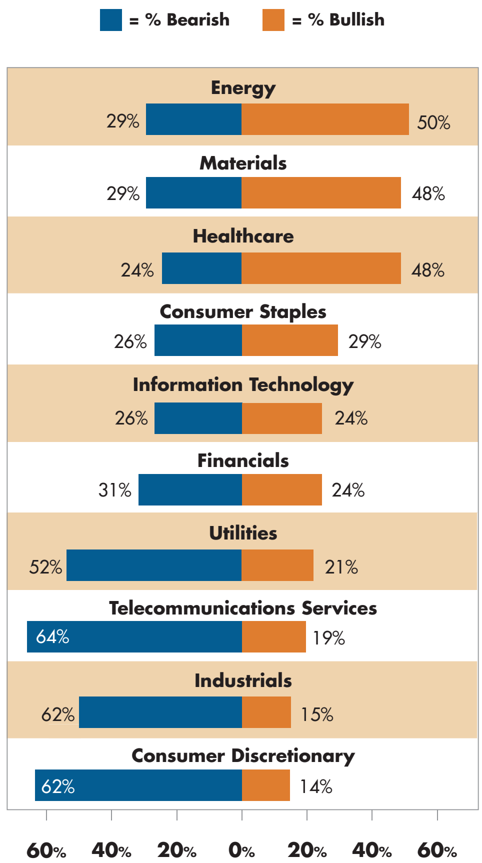
Managers remain positively disposed to energy and materials sectors as they factor in the continued strength in commodity prices. That said, the level of bullishness evident earlier in the year has cooled somewhat. Over the past quarter the percentage of managers favouring energy and materials sectors has fallen from 59% and 63% in the September to 50% and 48% respectively in December.

Negative sentiment to consumer discretionary stocks continues to be influenced by moderating economic growth, a slowdown in the housing cycle, higher oil prices and more recently the perception of a RBA tightening bias in cash rates. Listed property trusts also continue to be eschewed by managers. Sentiment to the telecommunications sector is the most negative of all sectors this quarter, with 64% of managers bearish on the sector prospects over the next twelve months. Sentiment appears to be primarily weighed down by the T3 sell down.

There is general consensus that the RBA is unlikely to raise cash rates significantly over the course of 2006. Moderating economic growth, subdued consumer sentiment, relatively benign inflation and current interest rate differentials with the rest of the world lessen the likelihood of any aggressive moves by the RBA. With initial fears of higher oil prices fueling a sharp increase in inflation dissipating, the market's negative sentiment to Australian bonds is also moderating. While managers remain negative on the outlook for Australian bonds with 53% of respondents bearish over the next twelve months, this is substantially lower than bearish sentiment in September (69%) and June (74%).

For this survey managers were asked to nominate two factors that they believed would have the largest influence on investment markets over the coming year. The majority of managers believe that corporate earnings (46% of all responses) will be the most important factor in investment market performance over 2006. Interest rates (28%) and energy/oil prices (23%) are, in their opinion, of secondary importance. Finally the value of the $A (2%) and geopolitical stability (1%) are thought to have little impact on the market in 2006.

**Manager Expectations by Sector**



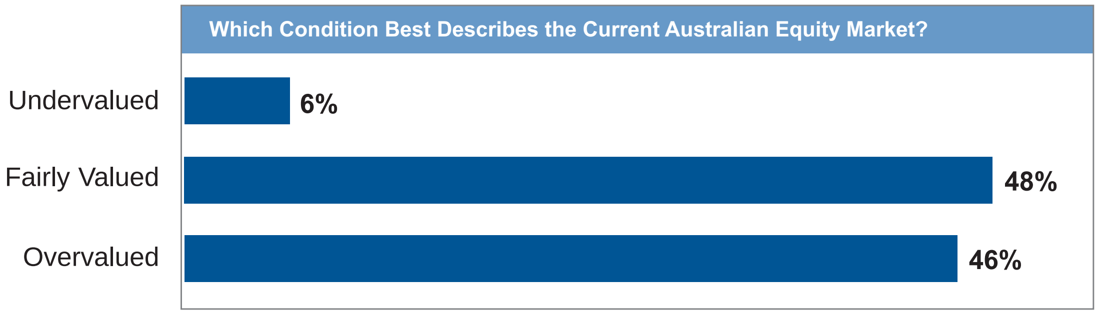

Note: Bearish = percent of managers responding with 1-3 on a scale of 1-7. Bullish = percent of managers responding with 5-7 on a scale of 1-7. Scores for neutral (4) are not included. See detailed charts on the following pages.

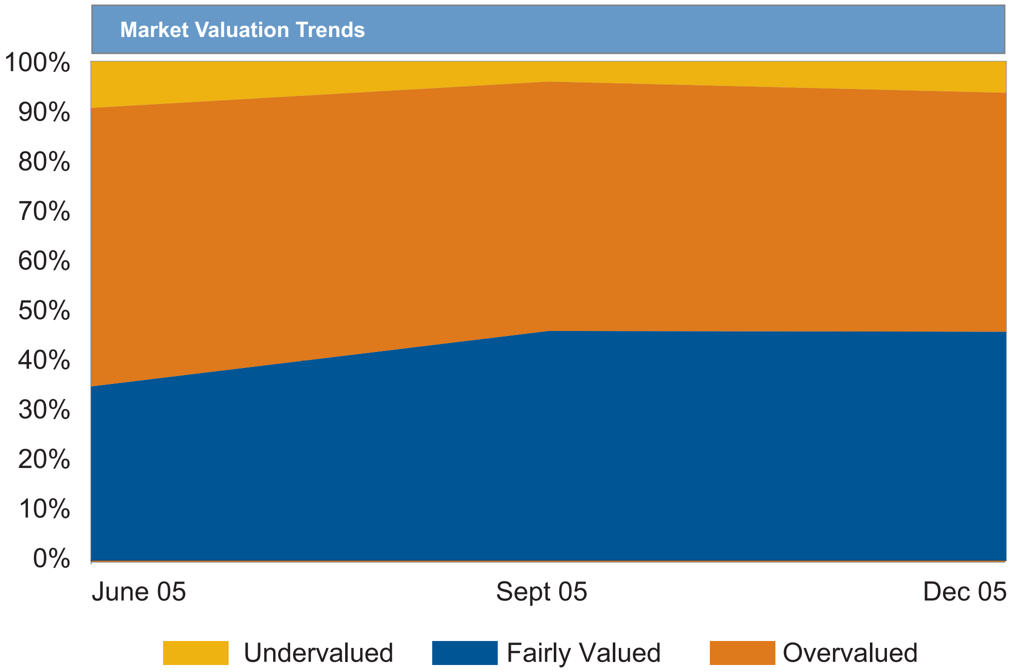
# Question 1 Results—**Valuation of the Australian Equity Market**

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

**Key Findings:**

- Only 6% of managers believe the market to be undervalued, down from 9% at the last survey.
- 48% believe the market is fairly valued, a drop of 2 percentage points from last quarter.
- 46% of managers now describe the market as overvalued, unchanged from September.
- Managers who believe the Australian equity market is overvalued now outnumber those who find it undervalued by a ratio of almost 8-to-1.



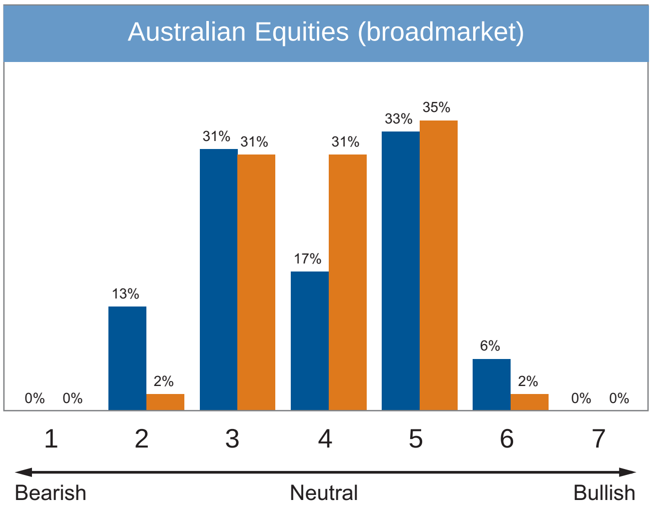
# Question 2 Results—**Asset Class Expectations**

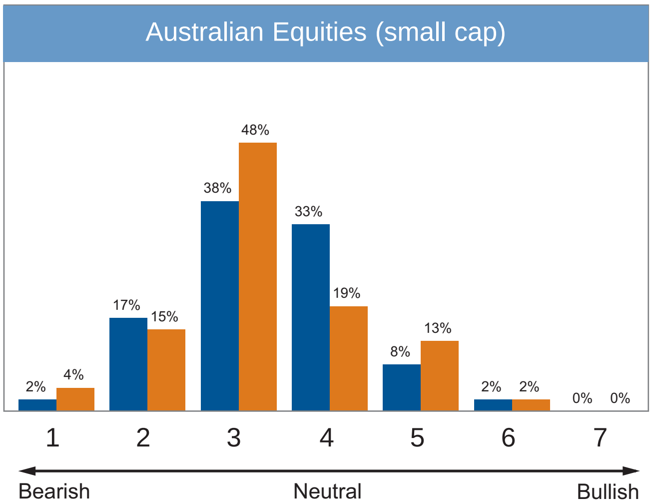
## What are your expectations for the performance of the following asset classes over the next 12 months?

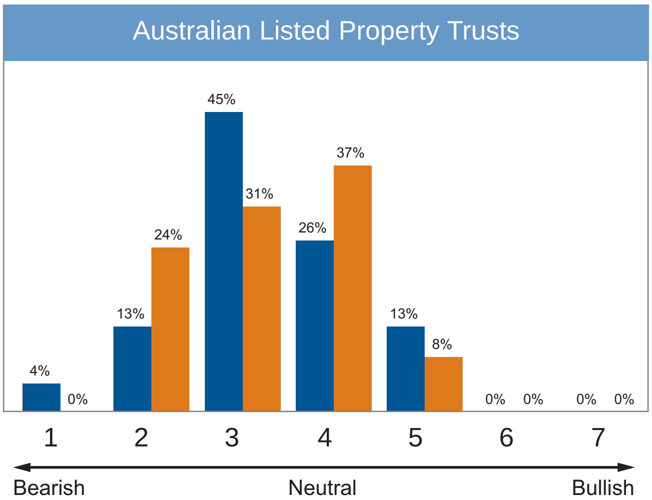
**Key Findings:**

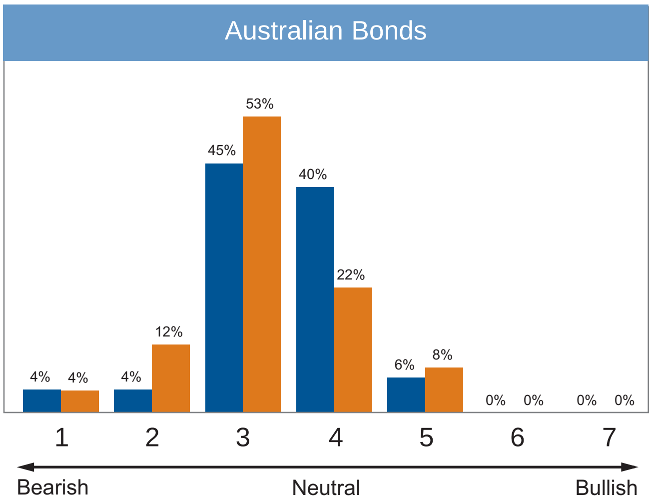
- Managers continue to favour international shares, with 67% bullish, up from 51% bullish last quarter.
- $A vs $US has experienced a large swing in sentiment, with 23% of managers now bullish compared with 48% last quarter.
- Managers remain bearish on small cap equities (56% bearish) and Australian bonds (53% bearish). However, bearish sentiment has been trending downward for both since the June quarter (73% and 74% bearish respectively).
- Opinion has further polarised on the outlook for broadmarket Australian equities (44% bearish / 17% neutral / 40% bullish). Bearish sentiment has been steadily increasing since June (27%) and September (33%).
- Bearish sentiment toward LPTs has increased 7 percentage points to 62% since last quarter.

**Scale is 1 to 7: 1 = "strongly bearish" 4 = "neutral" 7 = "strongly bullish" 4Q05 ■ 3Q05 ■**



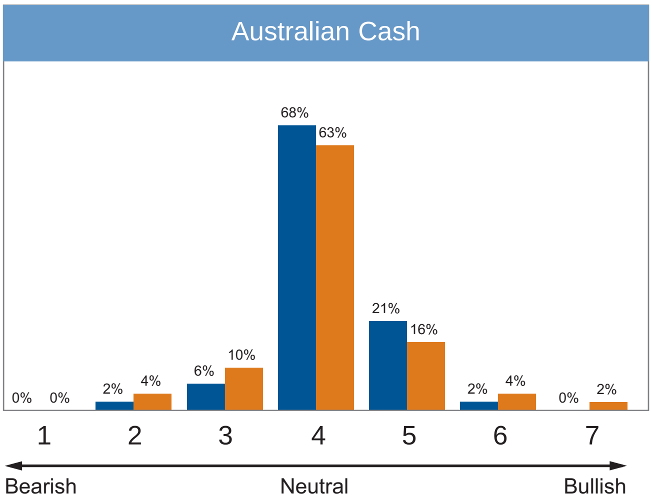



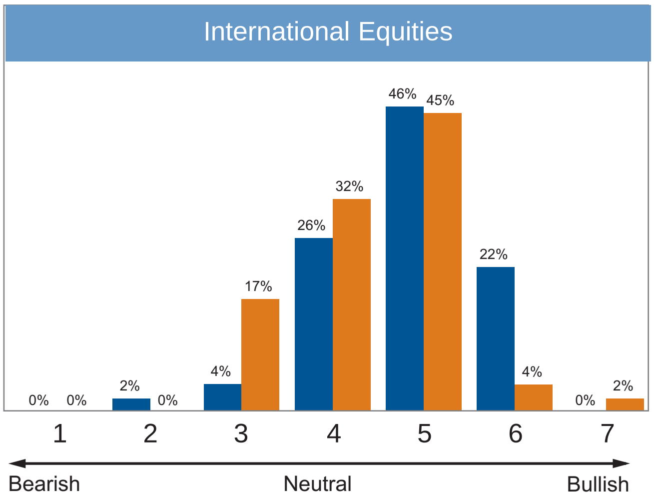



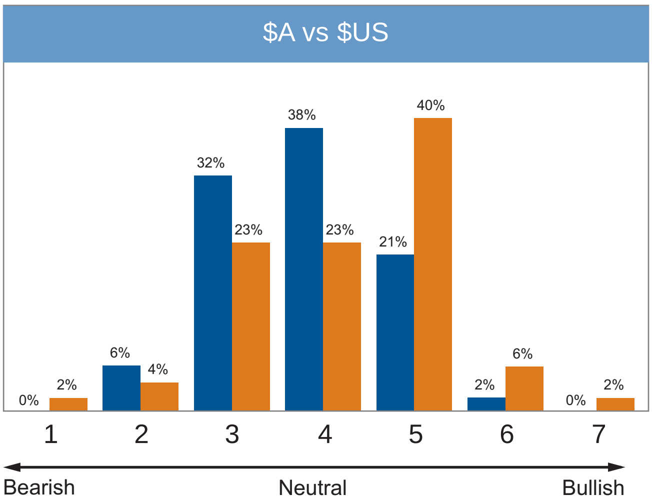

Note: Numbers may not add to 100 percent due to rounding.

# Question 2 Results—**Asset Class Expectations** (continued)

**Scale is 1 to 7: 1 = "strongly bearish" 4 = "neutral" 7 = "strongly bullish" 4Q05 3Q05**




Note: Numbers may not add to 100 percent due to rounding.

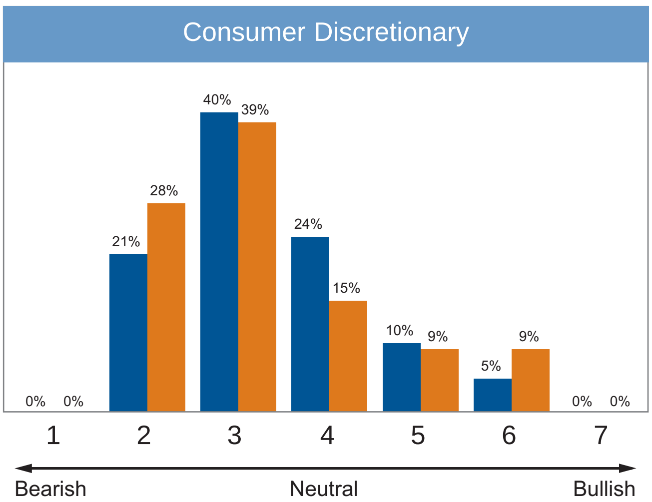
# Question 3 Results—**Sector Expectations**

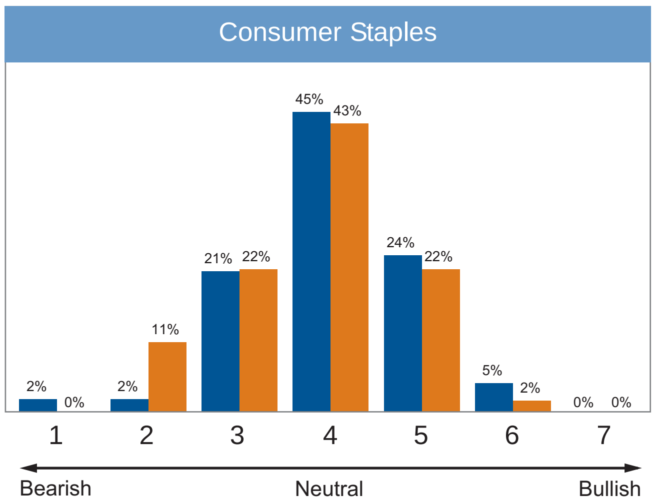
### What are your expectations for the performance of the following sectors over the next 12 months?

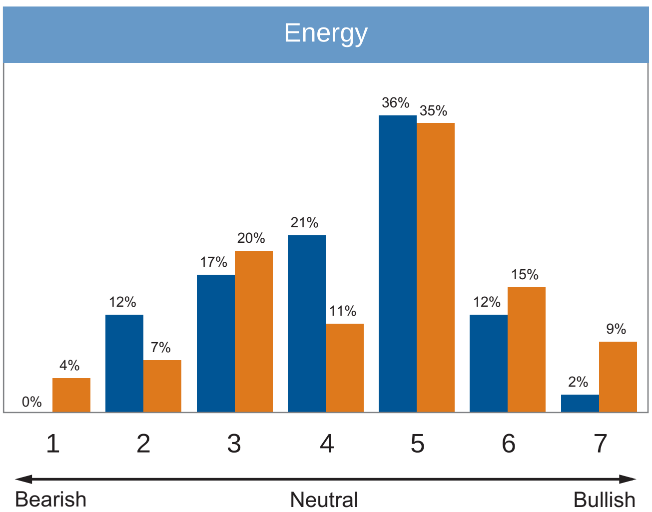
**Key Findings:**

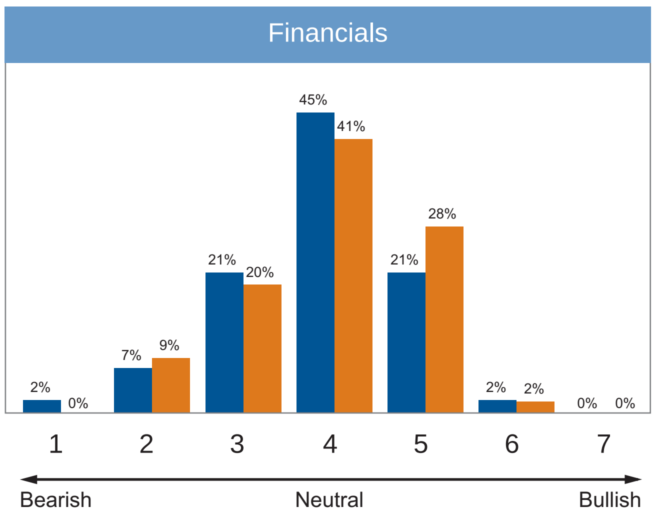
- The consensus outlook is weaker for every one of the ten sectors comapred with last quarter.
- Managers remain the most bullish on energy (50%), materials (48%) and healthcare (48%).
- Bullishness for materials has fallen 16 percentage points since last quarter.
- Managers are most bearish about telecommunications services (64%), consumer discretionary (62%), utilities (52%) and industrials (49%).
- Bearishness has increased for industrials by 25 percentage points since last quarter.

**Scale is 1 to 7: 1 = "strongly bearish" 4 = "neutral" 7 = "strongly bullish" 4Q05 3Q05**



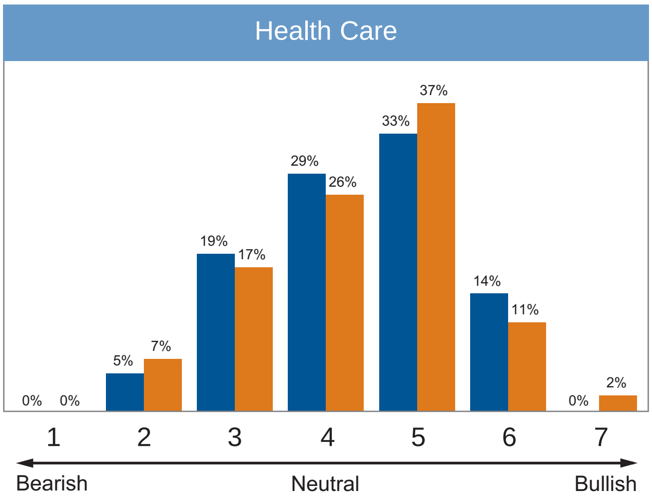



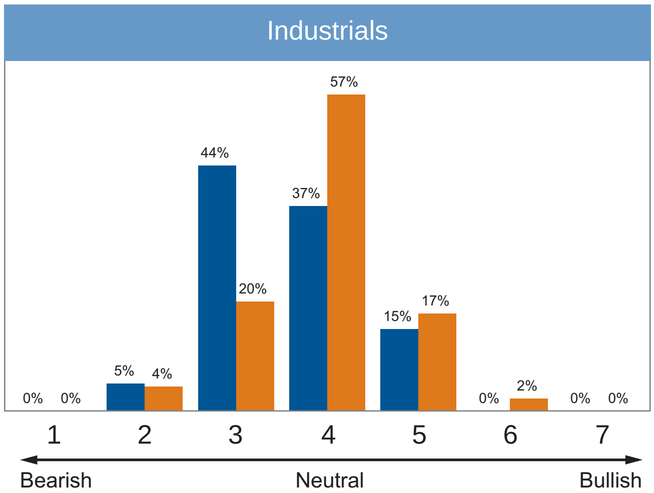



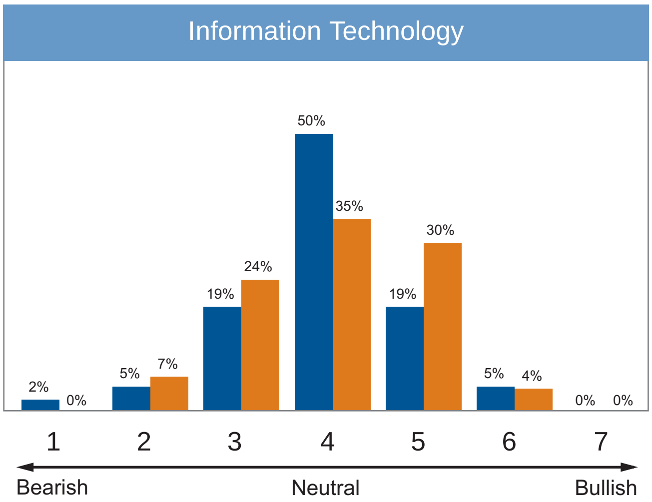

Note: Numbers may not add to 100 percent due to rounding.

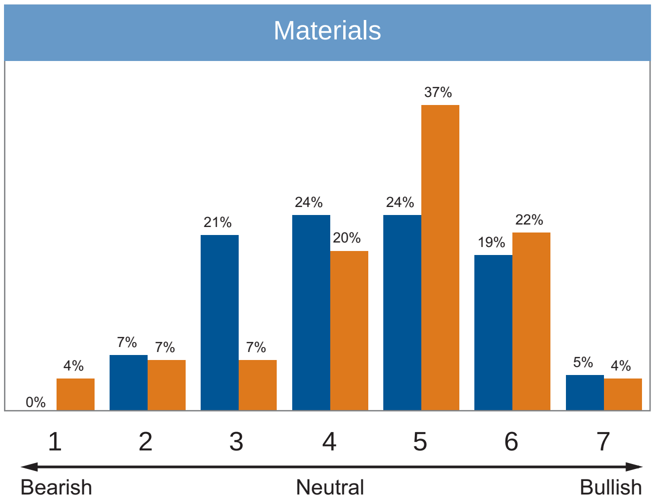
# Question 3 Results—**Sector Expectations** (continued)

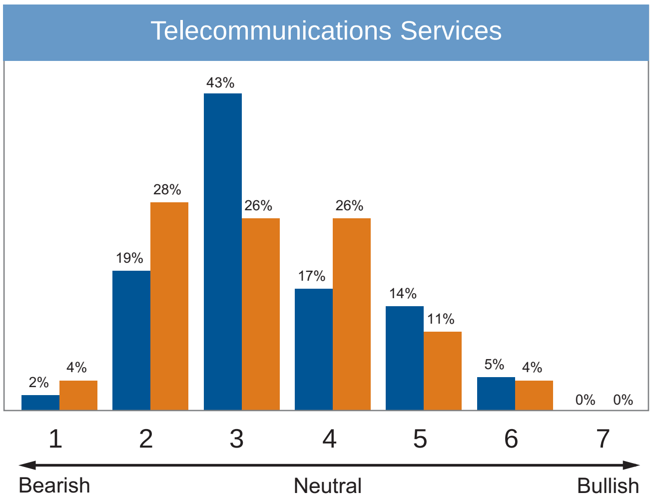
**Scale is 1 to 7: 1 = "strongly bearish" 4 = "neutral" 7 = "strongly bullish" 4Q05 3Q05**

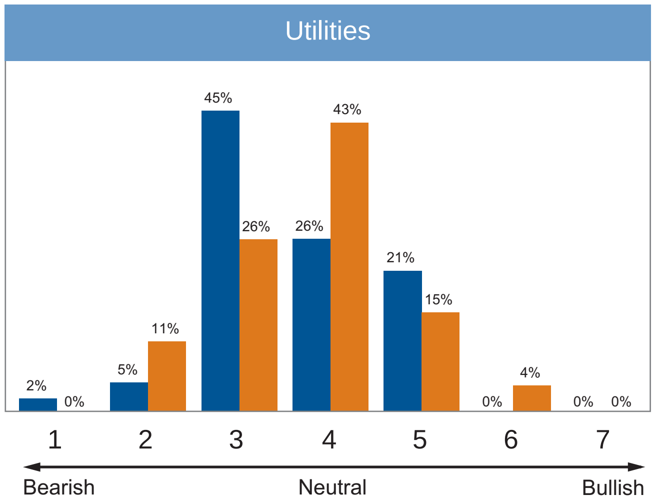


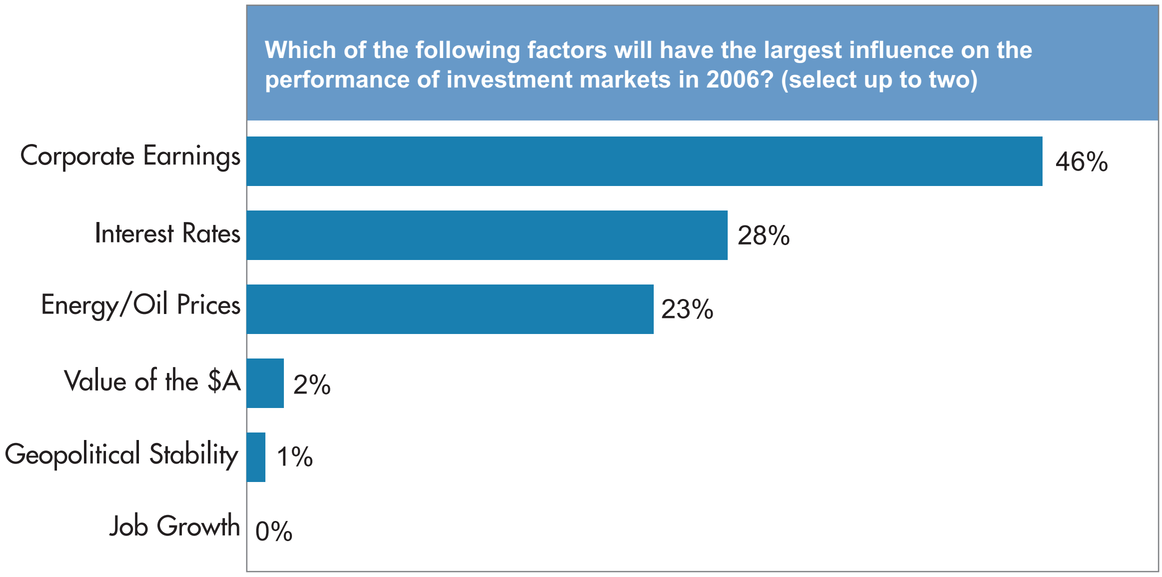

Note: Numbers may not add to 100 percent due to rounding.

# Question 4 Results—**Influencers on 2006 market performance**

## Which of the following factors will have the largest influence on the performance of investment markets in 2006?

**Key Findings:**

- Most managers believe that corporate earnings (46% of all responses) will be the most important factor influencing investment market performance in 2006.
- Interest rates (28%) and energy/oil prices (23%) are, in their opinion, of secondary importance.
- Value of the $A (2%) and geopolitical stability (1%) are thought to have little impact on the market in 2006 according to most managers.

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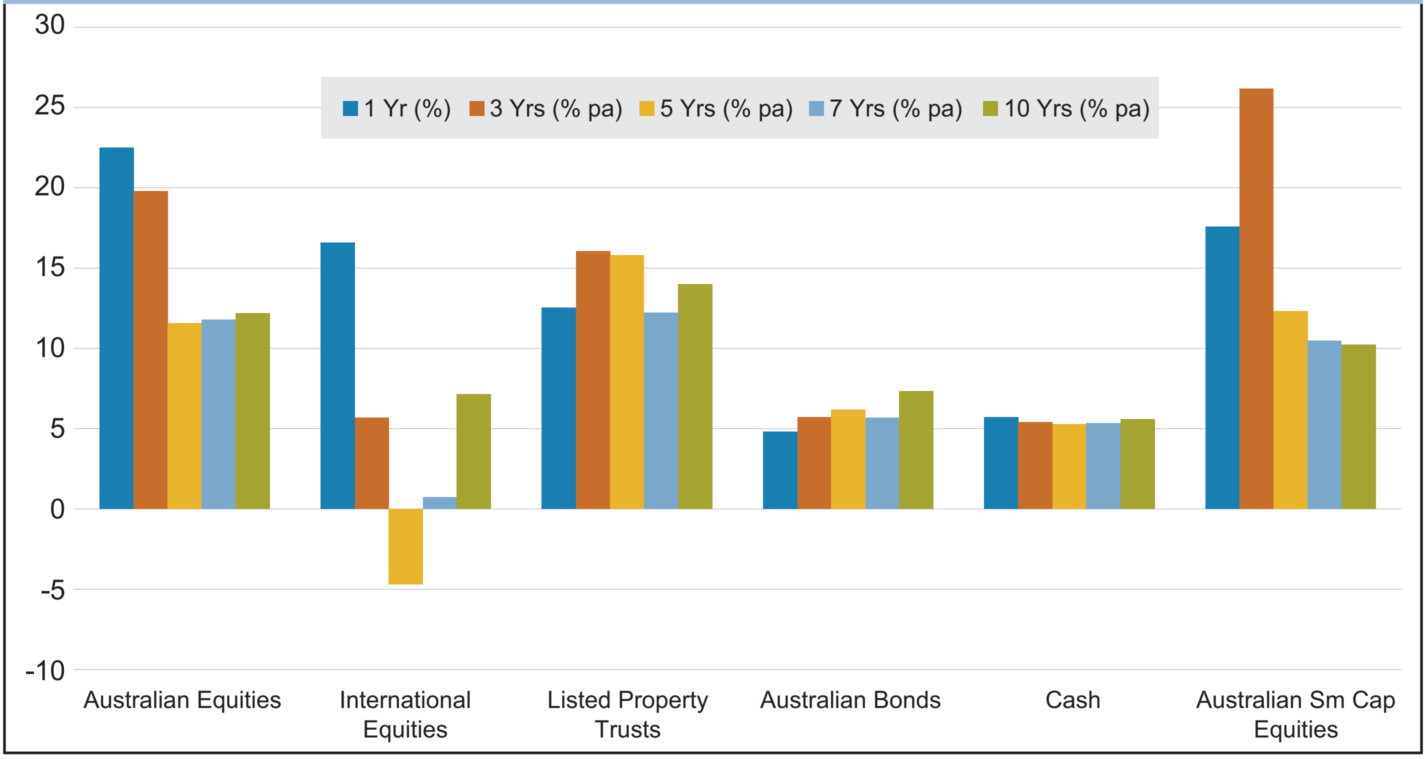
# Supplementary Information

## Chart: Annualised Asset Sector Returns to 30 November 2005




## Table: Annualised Asset Sector Returns to 30 November 2005

| Asset Sector | 1 Year (%) | 3 Years (% pa) | 5 Years (% pa) | 7 Years (% pa) | 10 Years (% pa) |
|---|---|---|---|---|---|
| Australian Equities | 22.50 | 19.78 | 11.56 | 11.78 | 12.19 |
| International Equities | 16.58 | 5.69 | -4.70 | 0.73 | 7.15 |
| Listed Property Trusts | 12.54 | 16.06 | 15.80 | 12.23 | 13.98 |
| Australian Bonds | 4.82 | 5.72 | 6.19 | 5.69 | 7.35 |
| Cash | 5.72 | 5.40 | 5.27 | 5.35 | 5.60 |
| Australian Sm Cap Equities | 17.58 | 26.19 | 12.31 | 10.46 | 10.21 |

Sources: **Australian Equities** - S&P/ASX 300 Accumulation Index; **International Equities** - MSCI World Net Dividend Reinvested Accumulation Index; **Listed Property Trusts** - S&P/ASX 300 GICS Property Trusts Accumulation Index; **Australian Bonds** - UBSWA Composite Bond Index; **Cash** - UBSWA Bank Bill Index; **Australian Small Cap Equities** - ASX Small Ords Index.

# Methodology and Background about Russell

## Methodology

Russell Investment Group conducted *Investment Manager Outlook* between November 28, 2005 and December 5, 2005. The survey was sent to investment managers with a variety of investment focuses but is primarily made up from Australian large-cap, multi-cap and small-cap equity managers, researched by Russell. Having a financial relationship with Russell was not part of the criteria for being included in the survey. In total, 48 investment management firms from Australia participated in the survey.

The large majority of individual respondents to *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 independent of *Investment Manager Outlook*, and responses to the survey are on a purely voluntary basis.

## About Russell Investment Group

Russell Investment Group is a global market leader among manager-of-manager investment firms, based on assets under management, as measured by The Cerulli Report.™ Russell has also been named the "Multi-manager of the Year" for two consecutive years by *Global Investor* magazine.

Russell, which launched its first multi-manager funds in 1980, advises clients on more than A$3.2 trillion in assets and delivers investment programs to more than 2,000 clients in 40 countries. Russell manages approximately $170 billion in assets in a variety of multi-manager funds. Russell also administers over A$19 billion in assets via their Customer Services and Administration area.

Institutional investors seek Russell's advice on evaluating and selecting talented investment managers, while organisations large and small take advantage of Russell's innovative investment management skills through our MULTI ASSET MULTI STYLE MULTI MANAGER investment programs.

More than 40 million individual investors also have access to Russell's services through a network of alliances that includes many of the world's top banks, insurance companies, broker/dealers, and independent investment advisors.

In Australia, Russell has expanded its operations to include a range of superannuation administration capabilities and now administers individual accounts for over 150,000 members across a range of corporate and government superannuation schemes, including those in the Russell SuperSolution Master Trust.

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

For more information, please visit www.russell.com/au

# Asset Class Definitions

### Broadmarket Australian Equities

Australian Equities 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. Equities may be purchased from sectors including financial, materials, industrial and energy.

The risks faced by Australian Equities 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 Equities market, may be considered in assessing the risk profile of Australian Equities.

### Small Cap Australian Equities

A subset of Australian Equities, Small Cap generally refers to companies with relatively small market capitalisation – below around $2 billion. Small Cap equities have some advantages over Large Cap equities 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 equities 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 Equities.

### Australian Listed Property Trusts (LPTs)

Australian Listed Property Trusts (LPTs) are collectively owned growth assets that invest in a portfolio of property. There are more than 45 LPTs on the Australian Stock Exchange, primarily run by property management groups such as Lend Lease, Westfield and Deutsche Asset Management. LPTs 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 LPTs include interest rate and market risk, security risk associated with property investment and distribution risk as dividends are not guaranteed by the LPT or ASX. The LPT sector has historically been 40% less volatile than the broad equities market. The S&P/ASX 300 GICS Property Trusts Accumulation Index could be considered in assessing the risk profile of Australian Listed Property Trusts.

### Australian Bonds

Australian Bonds (Australian 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 Warburg Australian Composite Bond Index could be considered in assessing the risk profile of Australian Bonds.

### 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 they generally provide 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 risk. The UBS Australian Bank Bill Index could be considered in assessing the risk profile of Australian Cash.

### International Equities

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

International equities entail different risks than those typically associated with domestic equities, including currency fluctuations, political and economic instability, accounting changes and foreign taxation. The MSCI World Net Dividends Reinvested Accumulation Index could be considered in assessing the risk profile of International Equities.

# Disclaimer

[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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