Russell Investments

Investment Manager Outlook

Date: March 2011

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Country: Australia

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

RUSSELL INVESTMENT MANAGER OUTLOOK

About the Investment Manager Outlook

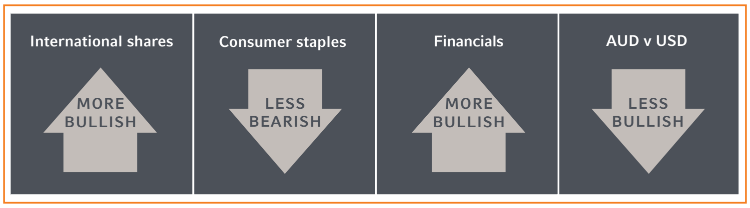
Welcome to the twenty-fifth edition of Russell's quarterly Australian Investment Manager Outlook, intended to generate a meaningful snapshot of Australian investment manager sentiment.

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 you or your investors will hopefully benefit from.

Each quarter, we survey around 40 of our 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

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



Compared to survey results from December 2010 Investment Manager Outlook survey, net balance basis.

Geopolitical events and natural catastrophes exerted significant influence over global and domestic markets for the quarter to 31 March 2011. Despite a strong start to the quarter for global markets with positive economic data coming out of the United States, sentiment was affected in March by ongoing political upheaval in the Middle East, a magnitude 9.0 earthquake in Japan followed by a tsunami which triggered a nuclear crisis. Closer to home, Australia experienced severe flooding in Queensland and Victoria during January which is expected to impact 2011 GDP in a material way. In this survey we profile the way managers have adjusted their outlook in response to these key events and consequently where they see opportunities in the current market environment.

The growth driven theme we observed in the December survey continued to evolve in the results of the March survey. Managers continue to strengthen their views on equity markets, with outlooks for other asset classes 'falling by the wayside.' The key difference this time around is that manager focus has taken on a distinctly international flavour with a net increase in sentiment to highest point since the survey's inception in 2005, as Exhibit 2A shows. The significant increase in the bullish view was predominantly responsible for this surge, bouncing from 67% to 88%. The number of bears has dropped off from 7% to a mere 3%. It is evident that surveyed managers expect continued strong performance from international equity markets; presumably this is while the powerful central bank stimulus (QE2) tailwind continues to support asset prices in the US and the strong Australian dollar makes offshore assets look relatively cheap.

Australian shares also continue to enjoy a protracted run of manager favouritism. While not reaching the same heights as the outlook towards international shares, the net view has set another record for the broad Australian sharemarket, increasing from 66% to 75% for the quarter. Bearish views have stayed the same at 3%, whereas bullish opinion has increased from 69% to 78%. In terms of valuation, the Australian sharemarket continues to reflect good value with none of the managers surveyed perceiving the Australian sharemarket to be overvalued. Similarly in our survey of US fund managers, only 5% of those managers surveyed believed that the US sharemarket is overvalued.

Managers backing growth assets as we head into a "risk on" environment

By Scott Bennett, Russell Investments

Sentiment towards growth assets hit a record in the March survey, with unprecedented support for global sharemarkets. For the first time in two and half years international shares were more favoured than Australian shares, signalling increased confidence in US growth and stability in other developed markets.

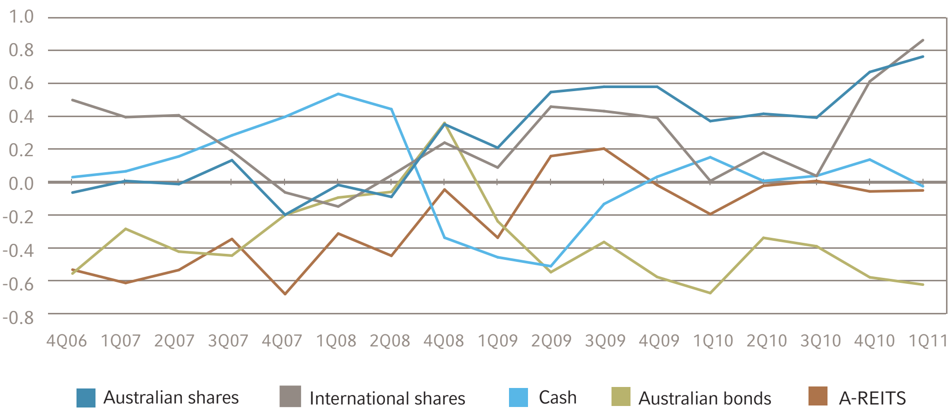
Australian small cap stocks, particularly miners, performed very well in the final quarter of 2010, outperforming the broader sharemarket by 6.8%. This exceptional short term performance has resulted in caution from some fund managers with one in five managers expecting a reversal of fortune over the next twelve months. In contrast only 3% of managers were bearish on the broader Australian sharemarket.

The Reserve Bank of Australia (RBA) kept the cash rate steady at 4.75% for the quarter. This was largely expected by most managers in the last survey with a fairly benign prior bullish view of 32%. The highly destructive Queensland floods have further affected sentiment however; the RBA estimates that the floods will reduce GDP growth by up to 1%. As a result interest rate expectations have been pushed out significantly and the bullish view on Australian cash has fallen to 16% in this quarter's survey. The other main determinant of the Australian interest rate outlook is the state of China's economy. The Chinese central bank has made concerted effort to keep their level of inflation under control, increasing rates three times since October 2010. This in turn lowers the risk of commodity cost-push inflation flowing through to Australia and further softens the domestic interest rate outlook.

"The highly destructive Queensland floods have further affected sentiment however; the RBA estimates that the floods will reduce GDP growth by up to 1%."

The AUD has traded within a well defined range, generally remaining at or slightly above parity for the quarter. Domestic floods, oil shocks, Chinese rate tightening and a Japanese earthquake haven't been enough to knock the AUD from its lofty perch. Clearly the unwavering strength of AUD continues to defy the belief of onlookers. The results from the March survey are particularly revealing; the net view of managers shows a steep increase in bearish views from

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



Managers backing growth assets as we head into a"risk on" environment (continued)

33% to 56% and a similar decrease in bullish views from 33% to 9%. Managers haven't been this negative on the AUD since the third quarter of 2008 – before the currency plunged from around 95 cents to 62 cents.

Australian bonds still retain the mantle of being managers most 'disliked' asset class. This is likely due to the very flat yield curve at the moment; investors are not being well compensated for holding longer-duration bonds due to a fairly benign rate outlook and consequently bearish views have increased from 61% to 66%. Interestingly, despite a more accommodative monetary policy outlook, managers' bullish view of property A-REITs continues to deteriorate, dropping from 28% to 23% this quarter. A-REITs in their traditionally defensive role haven't gained the favour of managers in what is evidently expected to be a more "risk on" environment.

Australian shares: Sector sentiment breakdown

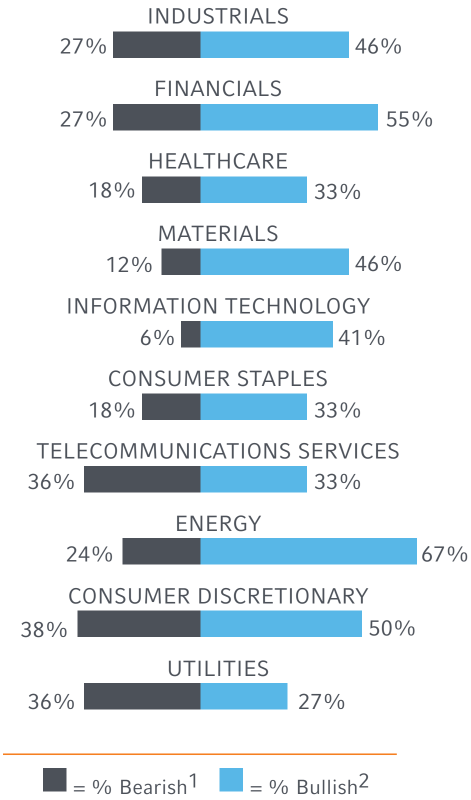
Domestically, sentiment towards the materials sector continues to be strong, with 2 in every 3 surveyed managers perceiving value in this sector. Indeed the net view of the materials sector (the bulls minus the bears) is the highest it has ever been in the surveys history. Underlying commodity prices continue to be supported by strong emerging market demand as well as speculative liquidity. Specifically, managers have high conviction that countries like China and India will steadily expand their appetite for Australia's natural resources despite a historically strong AUD.

The outlook towards the industrial sector continues to be positive, however the mood is less bullish than last quarter, with fund managers grappling with the impact of a carbon tax, higher oil prices and more subdued expectations for domestic growth.

Sentiment towards the financial sector has rebounded significantly from last quarter when the main concern was in relation to increased Government scrutiny and banking regulation. These views have since dissipated – the public has 'moved on' –and managers have consequently readjusted their bullish outlook from 30% to 55% while bearish views have remained flat at 27%.

Managers' opinion on oil prices and the impact that unrest in the Middle East has also directly translated into increased bullishness towards the energy sector. Like the materials sector, 2 in every 3 surveyed managers perceive value in this sector.

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. See detailed charts on the following pages.

COMMENTARY & ANALYSIS

Managers backing growth assets as we head into a"risk on" environment (continued)

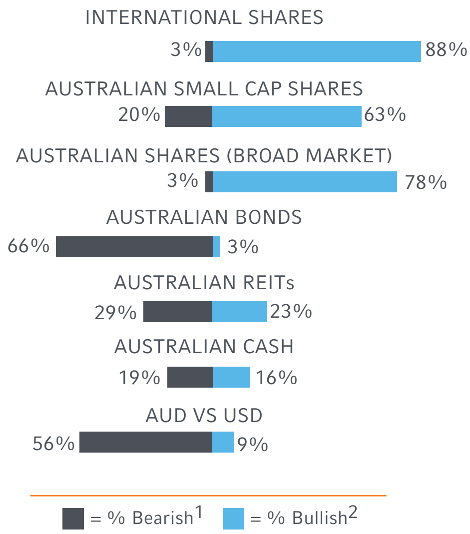
Factors which may weigh down markets in 2011

In the latest survey we asked managers what they believe are the main factors which may weigh down markets in 2011. The results, summarised in Exhibit 5A, indicate that managers expect that global macroeconomic/geopolitical issues will continue to dominate the Australian market. At the forefront of the surveyed items is the sustainability of China's growth. Continued Chinese economic expansion is key to Australia's prosperity as the benefits of the terms of trade flow through to the broader market. As mentioned previously, China is taking a strong stance on clamping down on inflation, which was last reported at 4.9% in February. The danger is that rising oil (and other commodity) prices – the second highest rated issue by managers – will cause rate hikes and potentially reduce growth in China. Although this issue has received less press and media attention than the crisis in the Middle East, clearly the message from the managers is that the risk of a China slowdown is a significant watch point for Australian investors.

Indeed most of the other top rated issues are inexorably linked together; civil unrest in the Arab world would likely lead to higher energy prices, which could cause a slowdown in China. As could food inflation, which represents approximately 35% of the average urban Chinese citizen's budget. A sluggish US economy would probably reduce demand for Chinese exports and cause a slowdown in growth.

Australia-centric issues such as a national skills shortage, domestic inflation, government intervention in the banking sector and increased union activism are rated relatively lower as a 'threat' compared to these global issues. This benign perspective, taken with the previously mentioned bullish manager sentiment towards the local market, indicates that managers currently view Australia as a relatively stable and rewarding investment environment. In the absence of any external macro shocks the outlook is very optimistic.

Exhibit 2C: Manager expectations by asset class



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Please refer to pages 11-12 for asset class definitions and page 13 for bearish & bullish definitions.

RESULTS

Valuation of the Australian sharemarket

Question 1:

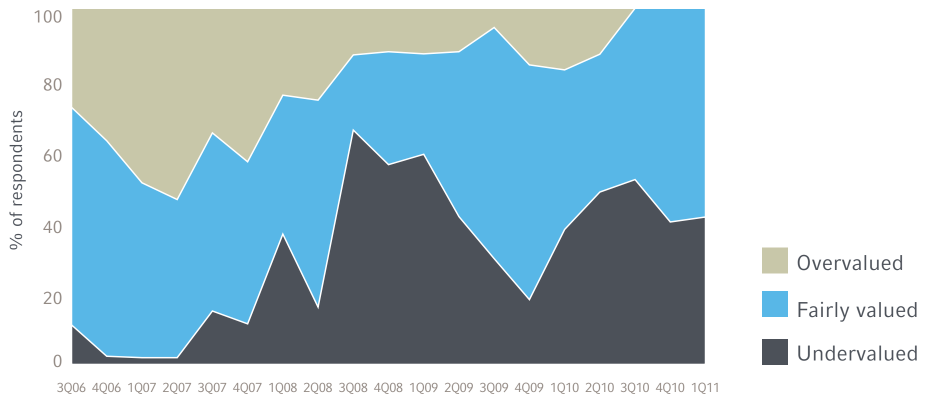
Which of these general valuation conditions best describes the current Australian sharemarket?

Key findings:

› Investment managers have indicated that the Australian sharemarket is reaching fair value, with the proportion of managers believing the market is undervalued increasing this quarter.

› For the third consecutive quarter, and only the forth time in the survey's history, none of the managers surveyed view the Australian sharemarket to be overvalued.

Exhibit 3A: Shifts in market valuation



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

"The Australian economy continues to perform well, benefitting from falling unemployment, a strong financial system and demand for our resources from emerging economies."

MATTHEW CAHILL
Perennial Investment Partners

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:

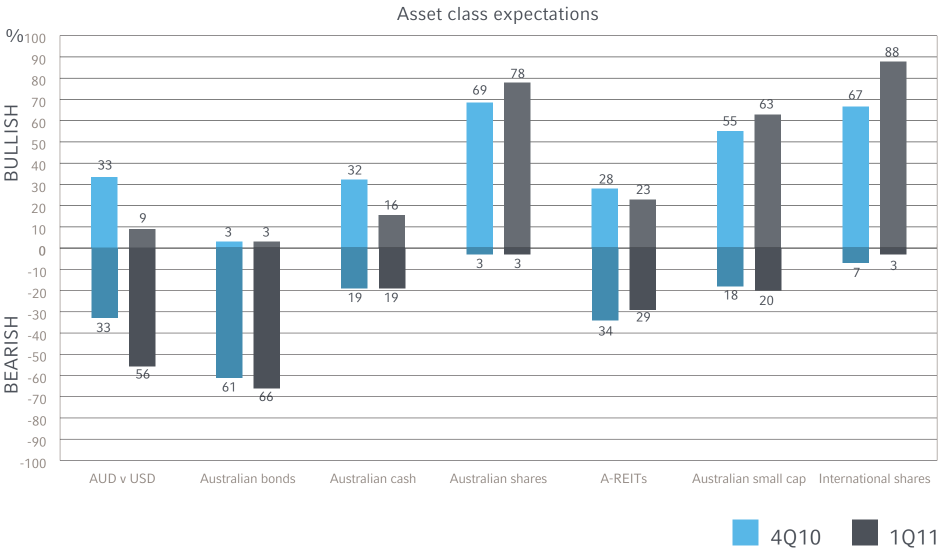
› Managers continue to be most bullish on equities, with broad market Australian shares, intranational shares and small cap Australian shares topping the outlook this quarter.

› The most notable shift in sentiment this quarter was again in the outlook for international shares. The net increase in sentiment is a signal of increased confidence in US growth and the stabilisation of other developed markets.

"The equity market has been driven by small cap resources which have dubious sustainability of earnings. The next leg of growth will come from larger caps with more sustainable earnings."

MARK NATHAN
Arnhem Investment Management

Exhibit 4A: Manager expectations – asset classes



RESULTS

Sector expectations

Question 3:

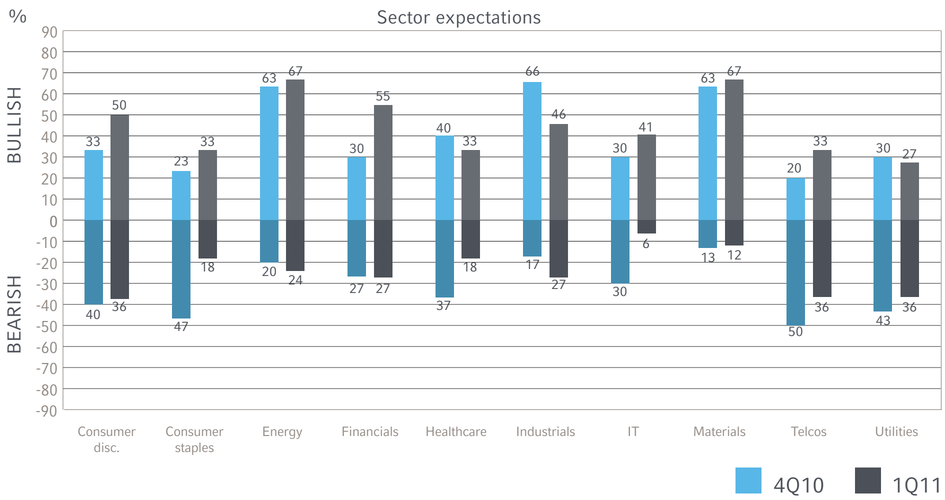
What are your expectations for the performance of the following sectors over the next 12 months?

Key findings:

› Banking regulation concerns have been allied this quarter with bullish views on financials rebounding strongly.

› Net view of the materials sector reached highest level in history of the survey, driven by strong appetite for resources from India and China.

Exhibit 4B: Manager expectations – Australian sectors



"The uncertainties of the global economic outlook and potential Australian policy decisions have weighed on the Australian market. We believe Australian equities offer attractive valuation levels as a result, especially financial and industrials."

ANDREW SISSON
Balanced Equity Management

RESULTS

Sharemarket expectations

Question 4:

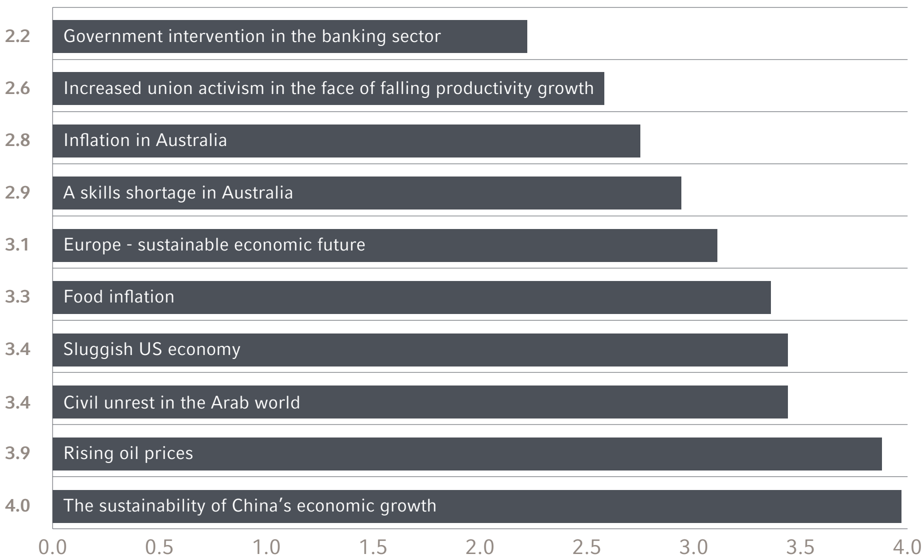
To what extent do you believe the following factors will weigh down markets over the coming year?

Key findings:

› Major issues managers believe will impact investors in 2011 are global not local.

› The risk of a China slow down is a significant watch point for Australian investors.

Exhibit 5A: Factors most likely to weigh down markets over the coming year.



Note: Each scenario was rated on a scale of 1-5. 1 = no impact. 5 = major impact.
The bars represent the average of manager responses.

"In an economic sense, the events in the middle east have been overshadowed by the recent natural disasters. The disruption to world production will be large in the short term, but will increase resource demand in the medium term as the reconstruction effort begins."

MARK NATHAN
Arnhem Investment Management

Methodology and about Russell Investments

Methodology

Russell Investments conducted the Investment Manager Outlook between 2 to 22 March. 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, 36 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.

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.

Asset class definitions

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)

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 MSCI World Net Dividends Reinvested Accumulation Index could be considered in assessing the risk profile of International shares.

General disclosures

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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