

View from the hill

HILLROSS INVESTMENT MARKET PERFORMANCE AT A GLANCE DECEMBER 2011

Market update

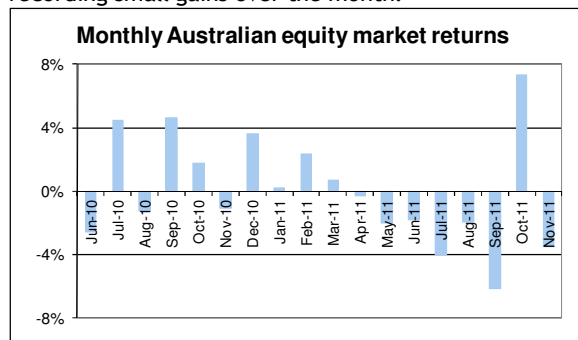
The table below provides details of the movement in average investment returns from various asset classes for the period up to 30 November 2011.

Asset class* (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	-3.5	-2.8	-6.0	8.0
Smaller companies	-3.7	-7.2	-12.1	15.0
International shares (hedged)	-1.3	0.4	0.2	9.5
International shares (unhedged)	0.9	2.8	-5.2	-3.9
Emerging markets	-3.6	-5.9	-17.4	6.2
Property - Australian listed	2.6	1.7	2.4	-0.9
Property - global listed	-3.5	-5.0	1.3	14.3
Australian fixed interest	1.7	2.1	10.5	6.5
International fixed interest	0.2	1.5	8.8	8.0
Australian cash	0.4	1.2	5.0	4.4

Australian shares

Following the strong rally on equity markets over October, investor sentiment was once again dented by concerns over the debt position of European governments. Rising European Government bond yields, including those of core countries such as France and Germany, was indicative of the lack of confidence in the debt management plans put in place to date. As a result of the worsening global sentiment, Australian resource and banking stocks were sold down heavily, with losses across these sectors averaging 7%. Concerns that a deterioration in confidence in the European banking system may lead to higher funding costs for Australian banks continues to weigh heavily on bank share prices.

There were, however, some better performances amongst the defensive sectors, with telecommunications, healthcare and utilities all recording small gains over the month.



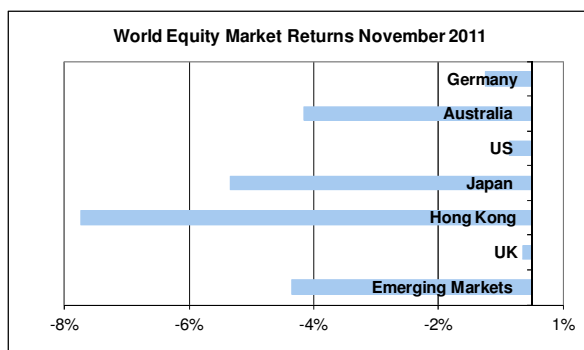
Source: S&P ASX 200 Index

Overall, the Australian share market posted a monthly loss, with the S&P ASX 200 Accumulation Index falling by 3.5% over November. This wiped out nearly half of the 7.3% gain recorded in October and brought the annual movement to negative 6.0%.

Smaller companies performed marginally worse than their larger counterparts, with the Small Ordinaries Index recording a decline of 3.7% over the month. Small cap stocks were weighed down by a 4.5% drop in the average price of the small mining sector. Interestingly this fall wasn't as large as that recorded by larger resource stocks.

International shares

With lower average allocations to the resource and banking sectors, international share markets generally performed better than those of Australia last month. The MSCI World Index showed an average fall in price of 1.3% for Australian investors. However, a fall in the \$A over the course of the month from US 105 cents to US 100 cents, meant that this loss for investors with unhedged currency positions was reversed by the currency movement (which increased the value of offshore investments in \$A terms). The MSCI World Index for unhedged investors rose by 0.9%.



Source: MSCI Indices. Returns in local currency of index

There was disparity in returns across global markets in November. Despite being at the centre of market concerns, share prices in some European countries held up relatively well. Losses in the United Kingdom and Germany, for example, were less than 1%. There were, however, more significant falls in other parts of Europe, with the French market losing 2.6% and Italy down 3.7%. Greece performed particularly poorly, with an 18% fall in prices taking its annual loss to 63%.

The United States market also fared relatively well with a decline of less than 1% recorded. There were some promising economic signs in the U.S. last month, with the probability of a recession appearing to be on the decline.

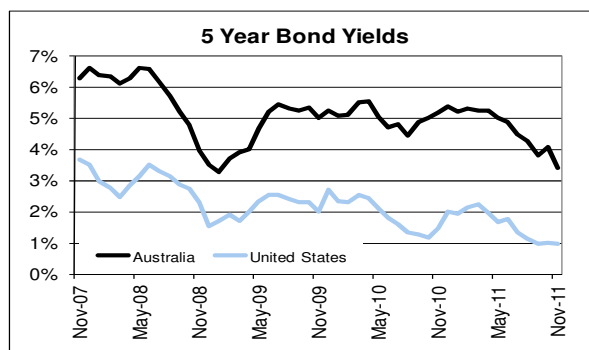
Emerging markets experienced larger losses than most developed markets over November. This could reflect their general sensitivity to global growth and commodity prices. In addition, concerns over the potential slowing of economic growth are having a significant impact on some Asian markets. The Chinese equity market was 8% lower, whilst Hong Kong was down 7%.

Interest rates

For the second consecutive month, the Reserve Bank announced a reduction in the overnight cash interest rate. The move in rates from 4.5% to 4.25% followed the Reserve Bank Board meeting in early December. The Board concluded *“that the inflation outlook afforded scope for a modest reduction in the cash rate”*.

Longer term interest rates also shifted significantly lower over November. Australia’s 5-year Government bond yield dropped from 4.1% to 3.4%, with 10-year bond yields now below 4%. The support for Australian bonds, which has the effect of driving up bond prices and pushing down yields, could be indicative of Australia increasingly being viewed as a “safe haven”, free from the debt problems entrenched in many other developed economies.

With yields already very low in the United States, there is little scope for further falls. Despite a more uncertain global outlook, the fall in U.S. Government 5-year bond yields was restricted to 0.03%, with 5-year yields closing the month at 0.96%.



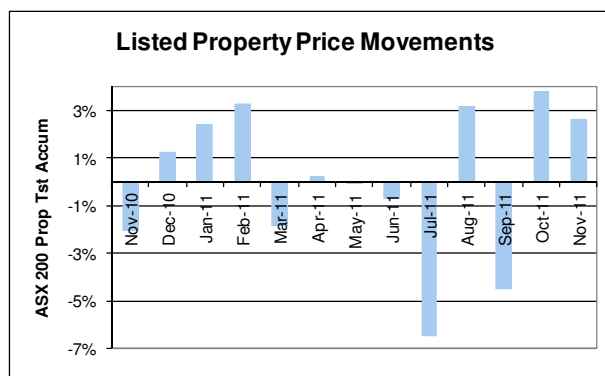
Source: Reserve Bank of Australia. United States Federal Reserve.

In contrast to the perceived “safer” government debt securities of Australia and the U.S., there was a decline in support for some European government bonds. Italian 10-year bonds for example rose from 6.1% to 7.0% over the month. In addition, French yields were also higher, moving from 3.1% to 3.4%, which highlighted a widening of the concerns around European debt into the larger “core” economies of the continent.

Property

It was a strong month for Australian listed property. Despite a decline in the overall equity market, the S&P ASX 200 A-REIT Index rose by 2.6%, and is now 2.4% above its level recorded a year ago. Westfield Group led the sector high over November, with a price rise of 6.4%.

With interest rates falling, the yields available on property have become more attractive in relative terms, and this may be providing support for the sector.



Source: ASX / S&P

Returns from global property were not a strong, with the UBS Global Property Index (\$A hedged) declining by 3.5% during November.

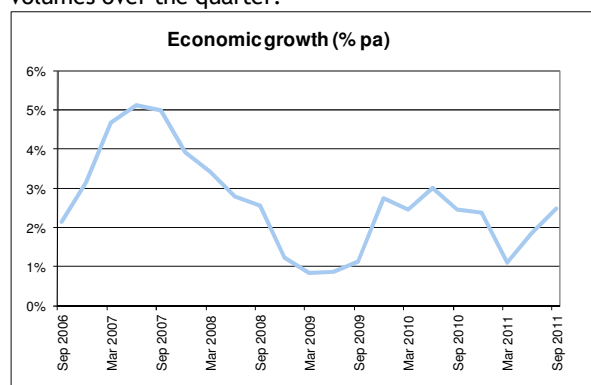
The Hillross tactical view

Asset class	Tactical view	Rationale
Australian equities	Overweight	Buying support for several non banking industrial sectors suggests that investors are seeking value away from the most globally exposed companies. Given a favourable local economic backdrop, current cheap equity valuations justify an overweight position to Australian shares. Growth opportunities would appear superior in Australia when compared with most major developed markets.
International equities	Neutral	Whilst the ongoing crisis threat coming out of Europe has meant that equities are trading at low valuations, buying opportunities still need to be assessed against a backdrop of an extended period of low or subdued economic growth for most major developed economies.
Property	Underweight	Commercial property values appear to have firmed over the past 6 months and this is providing some support for the Australian listed property sector. Global property trusts continue to appear over-priced relative to other asset classes.
Fixed interest	Underweight	Recent falls in longer term yields have pushed bond prices well below what is required for any meaningful compensation for inflation risks. Global government bonds are priced for an extended economic downturn, with virtually no or negative global inflation.
Alternatives	Neutral	Given the likelihood of ongoing volatility in equities and a lack of value in bond yields, alternatives should represent a material component of investment portfolios.
Australian cash	Overweight	The recent lowering of cash interest rates has slightly reduced the attractiveness of this asset class. None-the-less, cash yields are still above longer term government bond rates

The economy this month

Australian economy expands

National Accounts data for the September quarter highlighted significant growth in business investment. The economy expanded by 1.0% over the three month period, to bring the annual rate of economic growth to a healthy 2.5%. Led by the mining sector, a 12.7% jump in business investment made a major contribution to economic growth, whilst household consumption was also buoyant, rising by 1.2%. These positive movements more than offset a lower contribution from government spending and the leakage to domestic production from higher import volumes over the quarter.



Source: Australian Bureau of Statistics 5206

Employment weakens

November labour force data showed a 6,300 decline in the number of workers employed for the month. This pushed up the unemployment rate by 0.1% to 5.3%. Employment growth over the past year has been only marginally positive, rising by 0.4%. This compares to a cyclical peak in annual employment growth of over 3.5% in the second half of 2010.

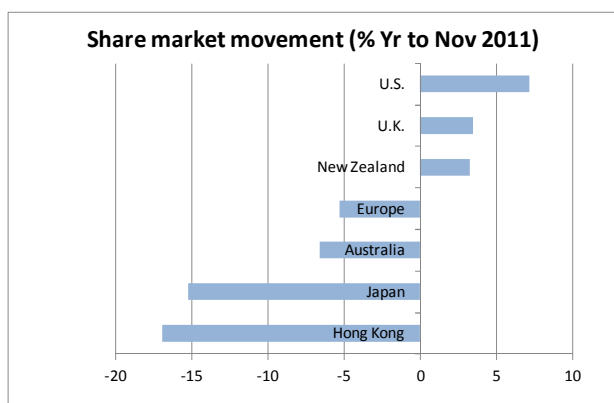
Mining sector infrastructure expands

Evidence that the mining boom in Australia is gathering pace was contained in construction activity statistics for the September quarter. Construction activity was 12.5% higher over the 3 months to be up 18.1% on an annual basis. Whilst residential housing construction remained in the doldrums, infrastructure development made the strongest contribution to overall growth. Infrastructure construction, much of it mining related, is now 48.4% higher than it was this time last year.

FEATURE ARTICLE: Why Australian shares are underperforming

Another month, and another period of under-performance from the Australian equity market. Despite Europe being at the epicenter of what is concerning investors, the 3.5% drop on the Australian equity market in November was materially worse than that recorded in some European markets and the United States (U.S.), where losses were less than 1%.

November continued a pattern of under-performance for the Australian market. In the year to the end of November, the U.S. share market has advanced by 7%, whilst the United Kingdom is 3% higher. New Zealand is also in positive territory, posting an annual gain of 3%. In contrast, the Australian share market has contracted 6% over the past year, which is 1% worse than the average across the troubled European markets.



Source: MSCI

Australia's negative absolute and relative equity market returns belie the current robustness of our economy and the undoubted growth opportunities available over the medium term. With interest rates falling, corporate balance sheets generally strong, government finances stable and a household sector experiencing both rising incomes and rising consumption spending, the economic environment should be supportive of company earnings growth and therefore share price appreciation. However, with each wave of concern over the outlook for financial stability in Europe, the Australian market has been sold down - at rates equal to or greater than those in Europe or the U.S.

Sector weightings are important

The relative dominance of resource and banking stocks in the Australian market provides much of the explanation for the poor performance of the Australian market when the fears of a global crisis escalate. Some 7 of the top 10 companies by size on the Australian Stock Exchange come from these two sectors.

Profit margins of companies in the resource sector are highly impacted by commodity prices and the general

level of global demand. The outlook for both these drivers tends to be very sensitive to the events taking place in Europe, given the potential for a financial crisis to dramatically drop the demand for commodities. Similarly, bank earnings are potentially at risk from a worsening crisis in Europe as any "freezing" of the financial system would cut bank funding lines and therefore see their balance sheets and earnings contract.

The fall in the price of resource and banking stocks is not unique to Australia. These sectors have declined in value across the globe, including markets such as the U.S. where overall share market returns have been positive over the past year. It is their high weighting, more than 60%, on the Australian market that makes their impact more significant here.

Some sectors have performed well

In addition to the impact of the potential for a European crisis, some companies in Australia have had to deal with other challenges that are likely to have had negative impacts on share price movements. For example, the rise in the Australian dollar has made it more difficult for exporters to compete; whilst it has also put local firms competing with imports at a disadvantage. The ongoing slump in residential construction activity has dented the earnings of some construction and building materials companies, whilst a spate of natural disasters has cut into insurance company margins.

However, not all sectors on the Australian share market have performed poorly over the past year. Utilities, property trusts, consumer staples and telecommunications have also posted positive results once dividends have been accounted for. This provides some comfort that the market has acted with some rationality and not ignored completely the relatively favourable economic backdrop in Australia.

Diversification remains important

Recent experience has highlighted the limitations and concentration of exposures available on the Australian share market. Even during a period when the outlook for the global economy has been poor, diversification into global share markets can be warranted. An allocation to global share that is made on an unhedged basis provides the additional currency related source of diversification. In the past, times of significant reduction in Australian share prices have often been accompanied by a falling Australian dollar, which has the impact of increasing the value of unhedged global investments.

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