

# Market Update

March 2012

The March quarter has seen financial markets reduce the probability of tail risk events; such as the breakup of the Euro and collapse in the European banking system. The European Central Bank (ECB) lending approximately \$1trillion (at 1%) to the European banking system was a major part of this reduction in tail risk and as such global financial markets have been stronger over the quarter. Continued positive economic news out of the US suggests that the economy is slowly recovering. This has also encouraged financial markets; with US equities at 4 year highs and bond yields rising over the quarter.

What issues will the market focus on moving in to the June quarter?

The main issues are likely to be;

- Is the recovering US economy sustainable? The US Federal Reserve (FED) is not convinced; and as such has continued to leave the door open to further quantitative easing which will keep bond yields low, place upward pressure on commodity prices and potentially strengthen the position of the \$A.
- Is China slowing too hard? As the Australian economy is strongly linked to China, any slowdown in China will have significant impact on Australia; and will be felt in a weak Australian equity market, weak \$A, falling cash rates and consequently falling term deposit rates.
- Budget Balance!! The government is committed to a budget balance; which will result one of the strongest contractions in government spending in recent times, in an environment where the economy could do with a less aggressive reduction in spending. With some sectors of the economy growing slowly, consumers are spending less and the strong \$A negatively effecting manufacturing and / or importing business. The Reserve Bank of Australia (RBA) does not want to reduce cash rates to below 4% as they believe the lack of productivity in the economy at present (which is leading to the difficulties in business adapting to the global challenges such as a weaker china and stronger \$A) cannot be solved by lowering interest rates. This will see more volatility in Australian bond markets.

All of these factors will see continued volatility in financial markets and high single digit returns will be difficult to achieve consistently.

The following provides a brief summary of the performance and strategy of the MAP pools.

## Cash Pool

MAP's cash pool continues to perform well returning approximately 1.20% for the quarter or an annualised rate of approximately 5.80% before fees. The current characteristics of the pool are as follows;

- Top 4 – NAB, AMP Bank, Bank of Queensland and Rural Bank;
- 55% of deposits are held in ADI's with a credit rating of A and 45% in BBB which are all investment grade; and
- 63 deposits with a weighted running yield of approximately 5.92% with a duration of 90 days or equivalent to a 90 day term deposit.

The continued stress banks face in wholesale funding will continue to see term deposits remain attractive. Recently some Authorised Deposit-Taking Institutions (ADI's) have started to progress towards the new Basel III regulatory rules that APRA require all ADI's to adhere too. There are some implications for APRA regulated super funds in that the new rules from an ADI's viewpoint;

- ADI's will favour taking deposits from retail investors and self-managed super funds as opposed to APRA regulated superfunds;
- Deposits held for greater than one year will be more attractive than deposits held for less than one year; and
- ADI's will require 31 days notice to break a term deposit, as opposed to one days' notice at present.

The investment team of MAP will continue working hard to maintain its competitive return with weekly liquidity, despite the new rules reducing liquidity and the attractiveness of term deposits. MAP will keep cash pool members updated as appropriate.

## Australian Equity Pool

The MAP strategy for equities continues to be based on the view that the resources/cyclical heavy nature of the index requires continued high commodity prices, and a robust global economy to rally beyond 5000. At 5000 too much good news is factored in and at 4000 too much negative news is factored in.

For 2012 the pool has a bias towards value stocks, which underperformed in 2011 as risky stocks were avoided in favour of defensive stocks such as Telstra. Small stocks also underperformed large stocks, due to concerns over the future growth prospects of the Australian economy. This strategy will perform well when volatility in markets fall and stock fundamentals become important rather than continued concerns over

the global economic environment.

In the last 3 months this strategy has generated approximately 11.50% in return before fees compared to 8.50% for the index (a difference of 3.00%). This level of performance is not expected to continue over the medium term; hence we are recycling this performance into a Blackrock Index Fund, which was appointed in late February. This will result in a reduction in our underweight to large cap companies and also reduce fees at the same time.

### International Equity Pool

For the March quarter the return of MAP's international equities is approximately 9.00% on the back of strong returns to emerging markets and a weaker \$A over the quarter. The strategy within international equities has always been to have a bias towards emerging markets and to neutralise the impact of the strong \$A on returns. We hedge 50% of our exposure to the major 4 currencies being the USD, Pound, Euro and Yen. This gives us a total hedging exposure of just under 40%.

Over the course of 2011 we also increased our exposure to indexing which has lowered the cost and increased our exposure to US stocks which was the best performing equity market in 2011. We have continued this strategy throughout 2012 and the pool has the following attributes:

- 40% in Indexed Developed Market Global equities;
- 19% in Emerging Markets equities; and
- 41% in Active management strategies including Global Small Companies.

### Diversified Property

For 2012, we have held unlisted property at maximum exposure of approximately 70% and Global REITS at 30%. Diversified Property returned approximately 3.75% for the quarter, around 1.00% higher than unlisted property returned, which is a direct result of our exposure to global listed property. Our exposure to Global REITS is through an indexing strategy, as we see the benefits of moving between listed and unlisted property outweighs any benefit derived from active management of listed property. This also assists in reducing the cost of the pool as unlisted property is expensive to hold. This strategy will continue in 2012.

### Multi-Asset Pools

The multi-asset pools are a combination of the single asset pools above with the addition of fixed interest and alternative assets. Generally speaking:

- The capital stable pool differs from a cash pool in two aspects, exposure to fixed interest and growth assets such as equities and property. This exposure, will over a period of time earn more than the cash pool.
- The balanced and growth pools are for investment horizons of at least 5 or more years. They have significant exposure to credit, equities and real assets such as property and infrastructure. The balanced pool can hold a maximum of 75% in growth assets, whereas the growth pool must hold at least 80% and can go to 100%.

Over the March quarter the pools will return approximately 3.5%, 6% and 7% for the capital stable, balanced and growth pools respectively. These returns are driven, in part, by the returns to the assets described above, but also a contribution of 2.75% from fixed interest. This asset class together with equities has seen the capital stable pool easily outperform cash over the quarter.

Alternative assets also contributed strongly to the returns for the balanced and growth pools. Infrastructure returned close to 2.5%, private equity a large 17% and hedge funds around 3.5% for the quarter.

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