Quarterly Review

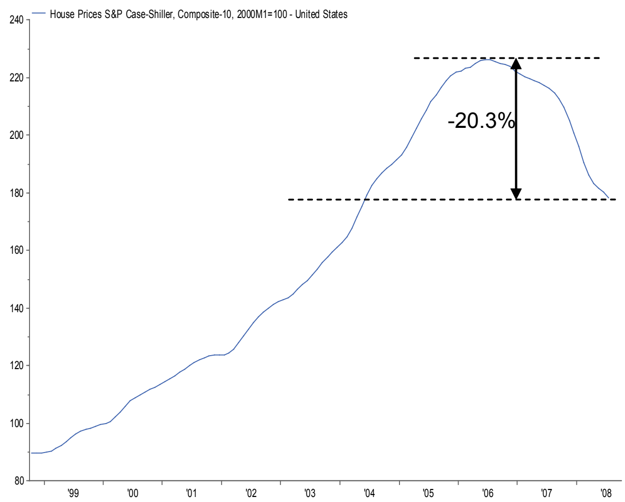
September 2008

Global financial crisis - How did we get here and where to now?

In this edition of the Aviva Investors Quarterly Review, Nick Pashias, Deputy Head of Equities, takes a look at the current global financial crisis, its origins and the current outlook.

The last fourteen months have seen massive losses and unprecedented volatility in financial markets across the globe. This has naturally caused investors to ask what happened and what is likely to happen from here.

Issues surrounding sub-prime lending in the US housing market are generally credited as being the main instigator of the current financial crisis. Between 1999 and 2006 there was a massive boom in the US housing market, as illustrated in figure 1. This boom was fuelled by a large increase in household debt, which was packaged up by banks and onsold as Collateralised Debt Obligations (CDOs) in financial markets. Since their peak in 2006, house prices in the US have fallen over 20%. This significant correction in US house prices has correspondingly resulted in the significant fall in CDO prices over the past twelve months.



Source: Factset
Figure 1 – US housing prices indexed over the last decade

Many home owners in the US struggling to make repayments on homes with negative equity (where the value of the property has fallen below the original amount of equity invested) are simply choosing to walk away from their debt obligations, leading to a rise in delinquent loans. These delinquent loans are what many investment banks packaged up and sold as CDOs to investors around the globe. The increase in sub-prime mortgage delinquencies has led to a sharp decline in the price of CDOs and major losses for the investors who bought them.

In April 2007, two hedge funds operated by Bear Stearns, which had significant exposure to CDOs from other banks, began to suffer. By July, banks that had loaned money to the highly leveraged Bear Stearns hedge funds began to issue margin calls demanding that the funds increase collateral against possible losses. Bear Stearns was forced to sell US$3.8bn of its CDOs into a down market, driving CDO prices even lower. Later that month the funds were declared bankrupt.

In Europe on 9 August 2007, BNP Paribas announced that it would close three investment funds with CDO exposure because problems in the US mortgage market had made it difficult to calculate the value of the funds' underlying assets. In response to the emerging signs of stress the overnight London Interbank Offer Rate (LIBOR, a key measure of credit risk within the broad banking system) jumped over 0.5%, doubling from its pre-crisis level. Figure 2 illustrates the difference between LIBOR and the US Federal Reserve Funds Futures rate, which can be interpreted as a gauge of corporate and consumer credit risk relative to the risk-free US government rate. The large spike in this measure represents a sudden increase in the reluctance of banks to lend to each other due to a lack of confidence and trust, and the seizing up of financial markets in general.

Source: Bloomberg
Figure 2 – Spread between LIBOR and US Federal Reserve Rate Funds Future Rate

Since then we have seen an unprecedented number of high profile banks and investment banks around the world collapse or require government support. These failures include the takeover of Bear Stearns, the placing of US mortgage giants Freddie Mac and Fannie Mae into conservatorship, the bankruptcy of Lehman Brothers, the bailout of AIG, and the banking takeovers of Washington Mutual, Wachovia and HBOS plc.

Numerous government interventions and globally co-ordinated central bank measures attempting to de-risk or give confidence to global markets do not appear to have been successful. By the end of the September quarter 2008, the difference between LIBOR and the US Fed Funds Futures rate stood at an unprecedented 2.20%, indicating that significant stress remains in the global banking system.

At the end of the quarter the US Treasury announced the Troubled Asset Relief Program (TARP) which proposed to purchase up to US$700 billion in troubled mortgage related assets. It is now a question as to whether this bailout package will be enough to absorb the assets that the private sector wants to offload from its balance sheets.

The US residential and commercial mortgage market amounts to US$14.8 trillion, with residential mortgages accounting for US$11.3 trillion. At the end of the June quarter 2008, the share of residential mortgages in delinquency or in the legal process of foreclosure stood at 9.16%. This implies there is over US$1.0 trillion in troubled debt in the residential sector and over US$150 billion in the commercial sector; a total of over US$1.15 trillion. These numbers are based on delinquencies as at the end of June 2008, and given the events of the last few months it is likely that the situation has significantly deteriorated since. As a result we believe the TARP may not be enough to cover the sheer volume of troubled mortgage related assets in the market.

Globally we are in a period of forced deleveraging, where the level of debt around the world is reducing and assets are being sold. The shortage of capital in the global banking system will lead to constrained credit conditions. As such we expect a prolonged period of below trend global GDP growth. In this environment interest rates are likely to fall and inflation is likely to be contained to acceptable levels.

While Australia faces a tough global economic environment it is worth remembering we have a strong and robust banking system, and the Reserve Bank of Australia (RBA) and the Federal Government have already acted promptly to provide interest rate and fiscal stimulus respectively to the economy.

What does this then mean for our clients? Despite the market turmoil, our focus remains unchanged. That is, our stock selection strategies and portfolio construction skills allow us to continue to identify attractive investment opportunities for our clients over the medium to long term. By leveraging the skills and experience of our investment team, together with the strength of our global parent company, we remain confident that over the medium to long term we will continue to identify attractive investment opportunities and achieve above market investment returns for our clients.

Market Review

The September quarter was certainly an eventful one for financial markets worldwide. Offshore events dominated late in the quarter, particularly in the US financial markets, causing markets to freefall to levels not seen since 2005. What occurred during the quarter can only be summarised as takeovers, mergers, marriages and bankruptcies that involved investment banks, commercial banks and mortgage lenders to name a few. The biggest of these were the placing of the two US behemoth mortgage players Fannie Mae and Freddie Mac into conservatorship, Lehman Brothers being allowed to fail, Merrill Lynch being taken over by Bank of America, and AIG being bailed out.

Locally, the S&P/ASX200 Accumulation Index fell 10.4% over the September quarter against the backdrop of the numerous global financial events. The global financial crisis and deteriorating global growth expectations left investors in a very bearish state of mind. Resources were hit hard, losing over 29% for the quarter – the worst three month performance by the sector since S&P indices began in 1992. Driving down the sector's performance was Aquarius Platinum (-64.9%), Straits Resources (-64.5%) and Panoramic Resources (-63.6%). Industrials were marginally negative, losing 2.2%, while Healthcare was the only positive sector in the quarter, returning 8.3%. The stocks which contributed strongly to the sector's performance were Resmed up 48.8%, Ansell up 37.1% and Cochlear up 35.9%.

Reporting season was relatively uneventful, with earnings releases generally meeting expectations. There was a cautious tone to many outlooks, which served as a precursor to the global events of September, including the US credit crisis boiling over and the initial failure of the Troubled Assets Relief Package (TARP) to pass US Congress. A second version of the TARP subsequently passed Congress. In addition to the above, the US Federal Reserve made further amendments to improve liquidity by providing facilities on top of injecting liquidity into the financial system. Liquidity injections were also common practice across all financial centres around the globe.

On the local economic front, the RBA began a less restrictive monetary stance during the quarter, cutting official rates by 0.25% to 7%; the first rate cut since 2001. The RBA cut rates again in October, by a surprising 1%, to leave the official cash rate at 6%. Further cuts remain in prospect, with easing local inflationary pressures and a global recession appearing likely, prompting money markets to price in further rate cuts for the remainder of 2008 into 2009.

A global response may be required to get through the deepening financial crisis, with the growing realisation that even with the TARP bailout passing there is still likely to be a long protracted period of pain for investors, with volatility being the only near certainty.

Below are short commentaries on each Aviva Investors fund, outlining their gross performance and attribution compared to their relative Benchmarks.

Australian Equities Fund - The fund returned -6.3% for the September quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index return of -10.4% by 4.1%. The best performing stocks for the portfolio over the quarter were a zero weighting in Fortescue Metals Group (0.81%) and an overweight position in Foster's Group (0.60%). Stocks detracting from performance were an overweight position in BHP Billiton and not owning Westpac Banking Corporation, which returned -0.53% and -0.52% respectively.

Dividend Builder - The fund delivered a return of 0.1% for the quarter, outperforming the Benchmark S&P/ASX 200 Industrials Accumulation Index of -0.5% by 0.6%. A zero weighting in Incitec Pivot (0.47%) and an overweight position in Insurance Australia Group (0.45%) performed the best for the portfolio over the quarter. Stocks detracting from performance were overweight positions in Wesfarmers and Suncorp-Metway which returned -1.07% and -0.82% respectively.

Elite Opportunities Fund - The fund returned -7.1% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index return of -10.4% by 3.3%. The best performing stocks for the portfolio were a zero weighting in Fortescue Metals (0.81%) and an overweight position in Stockland (0.69%). Being overweight Rio Tinto and not owning Westpac Banking Corporation returned -0.80% and -0.73% respectively, detracting from performance over the quarter.

High Growth Shares Fund - The fund returned -12.2% for the quarter, underperforming the Benchmark S&P/ASX 200 Accumulation Index of -10.4% by 1.8%. The best performing stocks for the portfolio during the September quarter were overweight positions in Toll Holdings (0.82%) and QBE Insurance Group (0.77%). Stocks detracting from performance were an overweight position in Rio Tinto and an underweight position in Westfield Group, which returned -0.86% and -0.66% respectively.

Small Companies Fund - The fund delivered a return of -17.3% for the quarter, outperforming the Benchmark S&P/ASX Small Ordinaries Accumulation Index of -18.1% by 0.8%. The best performing stocks for the portfolio during the quarter were zero weightings in Aquarius Platinum (2.02%) and Straits Resources (0.68%). Stocks detracting from performance were overweight positions in Citadel Resource Group and Kagara, which both returned -0.87%.

Sustainable Investment Fund - The fund returned -10.3% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index of -10.7%. The best performing stocks for the portfolio during the September quarter were an underweight position in Fortescue Metals Group (0.79%) and an overweight position in QBE Insurance Group (0.71%). Stocks detracting from performance were overweight positions in Australian Worldwide Exploration and BHP Billiton, which returned -0.57% and -0.52% respectively.

Listed Property Fund - The fund outperformed the Benchmark S&P/ASX 200 A-REIT Accumulation Index by 1.3% for the quarter. The best performing stocks for the portfolio during the September quarter were zero weightings in Valad Property Group (0.97%) and Centro Retail Group (0.56%). Stocks detracting from performance were an overweight position in Becton Property Group and not owning ING Office Fund, which returned -0.99% and -0.55% respectively.

Premier Fixed Income Fund - For the quarter the fund delivered a positive return of 4.2%. The return was below the fund's Benchmark return of 4.9% due to the fund's exposure to high yield securities, and a preference for overseas government bonds versus Australian government bonds. On the positive side, the fund was positioned to benefit from a steepening of the yield curve, reflecting our view that official interest rates will continue to fall, favouring shorter term securities over longer term ones.

High Yield Fund - The fund delivered a positive return of 1.5% for the quarter, underperforming its Benchmark by 2.8% over the quarter. This result was achieved as the ASX listed hybrid market fell by over 1% during the quarter, and extreme nervousness over global financial companies saw subordinated bonds issued by financials such as Macquarie Bank fall by over 15%.

Income Plus Growth Fund - The fund returned 1.9% for the quarter, underperforming the Benchmark by 0.5%. The best performing stocks for the Australian equities portfolio during the September quarter were an overweight position in Insurance Australia Group (0.62%) and not owning Incitec Pivot (0.47%). Stocks detracting from performance were overweight positions in Wesfarmers and Suncorp-Metway, which returned -1.04% and -0.88% respectively. For the High Yield component, the fund's holdings were negatively impacted by holdings of financial companies and property trust debt that have been the most exposed to the world wide credit crunch.

Australian Shares Fund* - The fund delivered a return of -6.2% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index of -10.4%. The best performing stocks for the portfolio over the quarter were a zero weighting in Fortescue Metals Group (0.81%) and an overweight position in Foster's Group (0.60%). Stocks detracting from performance were an overweight position in BHP Billiton and not owning Westpac Banking Corporation, which returned -0.53% and -0.52% respectively.

*Closed to new investments

Aviva Investors Investment Returns

Performance to 30 September 2008 (net of fees)

		3 mths %	1 yr %	2 yrs % pa	3 yrs % pa	4 yrs % pa	5 yrs % pa	Since Inception % pa	Inception Date
Australian Equities									
Aviva Investors Australian Equities Fund	Distribution	0.2	6.8	8.8	10.5	9.1	8.0	9.6	03/07/1995
	Growth Return	-6.7	-30.0	-9.1	-5.2	1.9	4.5	1.3	
	Total Return	-6.5	-23.2	-0.3	5.3	11.0	12.5	10.9	
Aviva Investors Dividend Builder	Distribution	0.9	3.6	5.8	5.8	-	-	5.7	06/09/2005
	Growth Return	-1.0	-27.8	-10.0	-4.7	-	-	-3.5	
	Total Return	-0.1	-24.2	-4.2	1.1	-	-	2.2	
Aviva Investors Elite Opportunities Fund	Distribution	0.4	9.2	11.8	17.7	17.1	15.2	13.6	18/11/2002
	Growth Return	-7.7	-29.1	-10.7	-11.3	-5.6	-1.2	1.4	
	Total Return	-7.3	-19.9	1.1	6.4	11.5	14.0	15.0	
Aviva Investors High Growth Shares Fund	Distribution	0.7	8.9	12.1	14.3	15.2	15.3	13.9	07/12/1999
	Growth Return	-12.6	-31.3	-12.6	-8.8	-4.0	-2.8	-0.8	
	Total Return	-11.9	-22.4	-0.5	5.5	11.2	12.5	13.1	
Aviva Investors Small Companies Fund	Distribution	0.4	16.0	20.2	26.3	28.7	25.0	17.0	19/11/1999
	Growth Return	-17.9	-35.8	-13.9	-16.1	-13.8	-9.9	-4.4	
	Total Return	-17.5	-19.8	6.3	10.2	14.9	15.1	12.6	
Aviva Investors Sustainable Investment Fund	Distribution	0.7	15.3	32.5	-	-	-	27.8	16/02/2006
	Growth Return	-11.2	-36.7	-33.8	-	-	-	-25.6	
	Total Return	-10.5	-21.4	-1.3	-	-	-	2.2	
Aviva Investors Australian Shares Fund *	Distribution	0.5	21.2	21.1	20.8	21.3	20.3	15.0	25/01/2000
	Growth Return	-6.9	-44.3	-21.2	-15.6	-10.4	-7.9	-5.8	
	Total Return	-6.4	-23.1	-0.1	5.2	10.9	12.4	9.2	
Listed Property									
Aviva Investors Listed Property Fund	Distribution	0.6	3.0	5.5	7.2	10.8	11.3	9.7	28/02/1994
	Growth Return	-0.8	-39.4	-17.1	-7.9	-7.4	-3.1	-0.7	
	Total Return	-0.2	-36.4	-11.6	-0.7	3.4	8.2	9.0	
Fixed Income									
Aviva Investors Premier Fixed Income Fund	Distribution	0.9	5.9	5.7	5.4	6.0	5.6	6.5	31/05/2000
	Growth Return	3.2	1.3	-0.3	-0.2	-0.4	0.1	-0.1	
	Total Return	4.1	7.2	5.4	5.2	5.6	5.7	6.4	
Aviva Investors High Yield Fund	Distribution	0.9	5.6	5.8	5.9	6.1	-	5.7	21/01/2004
	Growth Return	0.4	-9.2	-5.6	-3.8	-3.0	-	-1.9	
	Total Return	1.3	-3.6	0.2	2.1	3.1	-	3.8	
Aviva Investors Income Plus Growth Fund	Distribution	2.7	7.2	7.2	7.0	6.7	6.5	6.6	31/03/1998
	Growth Return	-1.0	-16.1	-6.9	-4.2	-1.8	-0.5	-0.2	
	Total Return	1.7	-8.9	0.3	2.8	4.9	6.0	6.4	

*Closed to new investments

Disclaimer: All returns are based on exit to exit unit prices for Professional Selection units, are net of fees and assume the reinvestment of income. Past performance is not a guide to or indication of future performance. At Aviva Investors' discretion, the management and/or performance fee may be partly rebated to professional, sophisticated or wholesale investors. The above information is of a general nature and has been prepared without taking account of your individual investment objectives, financial situation or particular investment needs. It is not intended as financial advice to retail clients. Before making an investment decision, you should consider the appropriateness of the information, having regard to your objectives, financial situation and needs. We recommend you consult with your financial adviser, who can help you determine how best to achieve your financial goals and whether investing in a fund is appropriate for you. Investment in the Aviva Investors Investment Funds will only be made upon receipt of a completed application form from the current PDS, a copy of which can be obtained from Aviva Investors.

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