

Investor Update

12 months to 31 December 2008



Economy - Global

The well documented sub-prime crisis placed downward pressure on the global economy all year. The pace of this deterioration escalated during the December quarter with economic data released confirming the global economy was in the process of recessing with the US, Europe, UK and Japan all recording negative quarters of economic growth for the September quarter. In fact for Europe and Japan it was their second quarter of negative economic growth.

Throughout the year a string of household names went bankrupt, were taken over, merged, received government assistance and in some instances nationalised.

The global policy response to the financial crisis has been remarkable. Central banks globally have been slashing their respective official cash rates. Additionally, throughout the year ongoing new liquidity initiatives and fiscal policy measures have been implemented. Initially the aim was to assist financial institutions remove distressed assets off their gridlocked balance sheets and free up liquidity, but this has now expanded into actions such as governments injecting capital directly into troubled financial institutions.

This year the US Federal Reserve has cut rates by 4.0% to just 0.25%, the European Central Bank actually raised rates mid year by 0.25% and then proceeded to cut rates by a total of 1.75% to 2.5%, the Bank of England cut rates by 3.5% to 2.0%, while the Bank of Japan lowered their cash rate to 0.1% from 0.5%.

Economy - Australia

Early in the year the Reserve Bank of Australia (RBA) remained concerned about the elevated level of inflation, resulting in their decision to continue to raise the official cash rate at that time. In the first half of the year the Australian economy had remained resilient to the global economic slowdown that was taking place. However, as we moved into the second half of the year the Australian economy began to feel the effects. To this end the RBA slashed the official cash rate lowering it by 3% over four months to 4.25%, and in the process removed six years of rate rises. Inflation was no longer seen as a problem.

Key leading economic indicators have now deteriorated quite sharply and whilst the slowdown is yet to be reflected in the employment data, the first six months of 2009 is expected to be a very challenging environment for the Australian economy.

Australian Sharemarket

2008 was one to forget for the domestic equities market. As with 2007, the past year has been dominated by the US sub-prime crisis, although this time the problems were much worse than the previous year. This was due to a morphing of the sub-prime crisis into a financial and economic crisis not seen since the Great Depression, caused by a combination of rising losses, a panic-ridden banking sector, and some poor policy decisions.

The equity market ended the year a staggering 38.4% down (S&P/ASX 200 Accumulation Index), with two fronts creating one of the worst calendar years on record. Debt became expensive or barely available due to the credit crisis, and the global economic environment took a severe downturn, placing considerable pressure on earnings prospects. In the first half of the year there was a perception that the problems were manageable, however, this was soon thwarted when US mortgage finance lending giants Freddie Mac and Fannie Mae were placed into conservatorship and then Lehman Brothers collapsed, eroding confidence and inducing panic.

Domestically, all ten industry sub-sectors finished in negative territory, with Health Care faring the best, down 10.8%, and Property Trusts performing worst, down 57.4%. Resources, on the strength of high commodity prices surged until May, but crumbled under deteriorating global growth prospects to be down 37% for the year, in line with the broader market's decline.

International and Australian Fixed Interest

Trading in fixed income markets over the year has been as wild and dramatic as anything seen in equity markets. As the crisis has escalated, a flight to quality into US Treasury securities, especially shorter term ones, has ensued. By year end all major global markets were trading at or near their yield lows. Yield curves globally also steepened sharply in response to the aggressive central bank rate cuts.

The local market also participated in the moves assisted by the dramatic sentiment shift with the changing RBA rhetoric. The benchmark 3-year bond, which spent most of the first half year trading between 6% and 7%, moved aggressively lower in the second half of the year in response to the aggressive rate cuts being delivered by the RBA, with expectations of more to come in 2009, and the flight to quality as investors became risk averse. It ended the year at just 3.29%.

The 90-day bank bill yield closed 3.09% lower at 4.15%, while 3-month cash futures closed 4.27% lower at 2.85%, reflecting both the delivered and expected RBA rate cuts. For the calendar year to date the benchmark UBS Composite Bond Index returned a positive 15.0%.

Fixed Income - performing when it matters most



In this edition of the Aviva Investors Investor Update, Nick Tribe, Senior Manager, Fixed Income, takes a look at the current climate and specifically the fixed income space and its outlook for 2009.

The year 2008 was certainly a remarkable year.

Fixed income markets were at the epicentre of what is now being referred to as the GFC – Global Financial Crisis, the causes of which have been well documented over the last year. But how has the fixed income market performed during this period? Well it depends where you were invested. The more of your fixed income allocation that was invested towards credit, the lower your returns would have been, as credit was not the place to be in 2008 from a fixed income perspective.

Let's have a look at the performance of the components of the UBS Composite Bond Index for the full year, remembering that this index is the fixed income market equivalent of the "All Ords". It is the most widely used benchmark in Australia for fixed income products.

The table below shows the major sector returns that comprise the UBS Composite Bond Index:

Sector	1 year	6 months	3 months
Government Bonds	19.1%	15.7%	8.5%
Semi-government Bonds	16.2%	12.7%	6.3%
Corporate Bonds	10.7%	8.7%	5.4%
Supra/Sovereign Bonds	15.3%	12.1%	5.5%
UBS Composite Bond Index	15.0%	12.0%	6.3%

Table 1 - Major fixed income sector returns (2008)

Source: UBS

Simplistically the return of a fixed income security is made up of the running yield, or the effective interest rate earned, and capital movements. When yields fall capital gains are generated, and the reverse is true when yields rise.

Some key observations from Table 1:

- Commonwealth Government bonds, often considered to be risk free, were the place to be in 2008 given they benefited from the flight to quality, pushing yields down more than the other sectors.

- Semi-government bonds were not far behind given they are highly rated, liquid and the next best thing to a Commonwealth Government bond.
- Corporate bonds still delivered a respectable return but lagged the returns of the government and semi-government bond markets as they did not fall as much in yield, so had less capital gains.
- Supra/sovereign bonds, holding similar characteristics, performed broadly in line with semi-government bonds.

The reason investors have fixed income in a diversified portfolio is to provide exactly that – diversification. As shown in Table 1, by having an allocation to fixed income – and we mean the more traditional type – a portfolio would have benefited from strong returns and offset some of the losses from sharemarket exposures. It is proof that fixed income provides "insurance"; performing when it counts. 2008 was a year when investors needed it to perform and it did – remaining true to label. In fact, the fixed income market delivered its second highest calendar year return since the end of 1994.

So in light of the exceptional returns of late, is the coming year the time to avoid fixed income in favour of cash options? For the following reasons we would say resoundingly "no":

- Fixed income is still likely to outperform cash given it has an average running yield of 4.9%, above the current cash rate of 4.25% which is highly likely to fall even further through monetary policy easing.
- Historically the fixed income market has outperformed cash in the two years following the last official cash rate hike – we are currently not even one year into this period.
- Credit markets – which struggled so much last year – are likely to deliver better returns than government bonds this year because they have a high starting yield, as well as offering the prospect of capital gains as market participants become less risk averse.
- In terms of government bonds, inflation is very much last year's news and is unlikely to be a factor this year and possibly into 2010. This should allow interest rates to be cut further and remain at lower levels for some time, providing the potential for capital gains, further boosting returns.

Opposite are short commentaries on each Aviva Investors Personal Choice fund, outlining their gross performance and the main contributors to performance.

For some time now we have been talking about having a diversified fixed income allocation because it's better for you long term. Better in the sense that "through the cycle" by having a mix of traditional Australian fixed income, international fixed income, and the ability to have exposure to higher yielding securities, inflation linked bonds and cash will deliver a better risk return profile when compared solely to cash or Australian fixed income.

This is why our Premier Fixed Income Fund, available through our Professional Selection suite of products, is a fully diversified fixed income fund. Importantly the fund's foundation remains the Australian fixed income market, together with an allocation to the international fixed income market as well as an exposure to higher yielding securities. The characteristics of this fund provide diversification; ensuring your fixed income allocation will still perform when it counts, as well as providing the diversification benefits of fixed income when used as part of an overall portfolio.

Our Premier Fixed Income Fund delivered a very healthy gross return of 10.7% over the course of 2008. As we enter 2009 the fund is well placed to produce another year of strong returns – the average yield of the fund is attractive, currently at 6.1%, which is 1.6% above its benchmark yield, and well above the prevailing official cash rate of 4.25%, which is expected to fall even further throughout the year.

Falling inflation and a weak economy allow for even lower interest rates and the potential for further capital gains. Additionally the fund remains exposed to higher yielding securities via the fund's high yield component. These are largely better quality securities caught up in the current credit crisis and now offer very attractive yields in the order of 13.8%. As such, another year of strong returns remains in prospect.

For further information regarding the Premier Fixed Income Fund please refer to our Professional Selection PDS, available from our Investor Services team on 1800 671 849 or via our website at www.avivainvestors.com.au. Before making an investment decision we recommend you consult your financial adviser.

Australian Shares Fund - the fund delivered a return of -21.6% for the six months to December 31, outperforming the Benchmark S&P/ASX 200 Accumulation Index of -26.8% by 5.2%, while over the year the fund outperformed the index by 4.5%.

The main contributors to performance during the year were an underweight position in Commonwealth Bank and an overweight position in Telstra Corporation. Stocks detracting from performance were overweight positions in Rio Tinto and Fairfax Media.

Elite Opportunities Shares Fund - the fund returned -19.8% for the half year, outperforming the Benchmark S&P/ASX 200 Accumulation Index return of -26.8% by 7.0%, while over the year the fund outperformed the index by 10.4%

Stocks positively contributing to performance for the year were overweight positions in Origin Energy and Telstra Corporation. Being overweight Rio Tinto and Asciano Group detracted from performance over the year.

High Growth Shares Fund - the fund returned -23.8% for the six months, outperforming the Benchmark S&P/ASX 200 Accumulation Index of -26.8% by 3.0%, while over the year the fund outperformed the index by 6.5%.

The main contributors to performance for the portfolio during the year were overweight positions in Origin Energy and Newcrest Mining. Stocks detracting from performance were overweight positions in Rio Tinto and Asciano Group.

Listed Property Fund - the fund delivered a return of -25.6% for the six months to December 31, outperforming the Benchmark S&P/ASX 200 A-REIT Accumulation Index of -33.7% by 8.1%, while over the year the fund outperformed the index by 5.8%.

The main contributors to performance over the year were zero weightings in Valad Property Group and ING Industrial Fund. Being overweight Becton Property Group and underweight CFS Retail Property Trust detracted from performance over the year.

Small Companies Fund - the fund delivered a return of -43.2% for the half year, underperforming the Benchmark S&P/ASX Small Ordinaries Accumulation Index of -42.0% by 1.2%, while over the year the fund outperformed the benchmark by 5.7%.

The main contributors to performance over the year were overweight positions in Queensland Gas Company and Incitec Pivot. Stocks detracting from performance were overweight positions in Nomad Buildings Solutions and Kagara.

Income Plus Growth Fund - the fund returned -6.4% for the six months, underperforming the Benchmark³ by 4.1%, while over the year the fund underperformed the index by 3.4%.

The main detractor from performance came from the fund's credit investments, in particular the fund's exposure to financials and real estate. In the fund's equities component, the main contributors to performance during the year were overweight positions in Telstra Corporation and Insurance Australia Group. Stocks to detract from performance were overweight positions in Fairfax Media and Wesfarmers.

3 Benchmark is 40% S&P/ASX200 Industrials Accumulation Index & 60% UBS Australia Composite 0-5 Year Index

Aviva Investors Investment Returns

Performance to 31 December 2008 (net of fees)

		6 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 Shares Fund	Distribution	1.1	16.4	17.3	18.3	19.0	18.3	9.7	28/02/1987
	Growth Return	-23.5	-51.6	-30.8	-21.6	-16.7	-12.4	-1.3	
	Total Return	-22.4	-35.2	-13.5	-3.3	2.3	5.9	8.4	
Aviva Investors Elite Opportunities Shares Fund	Distribution	0.2	7.0	8.7	14.3	14.7	13.1	11.1	29/11/2002
	Growth Return	-20.6	-36.0	-19.2	-15.1	-10.4	-4.8	-0.1	
	Total Return	-20.4	-29.0	-10.5	-0.8	4.3	8.3	11.0	
Aviva Investors High Growth Shares Fund	Distribution	0.4	5.6	9.4	12.2	13.2	13.5	12.7	02/12/1999
	Growth Return	-24.6	-38.8	-18.8	-14.2	-9.3	-6.5	-2.5	
	Total Return	-24.2	-33.2	-9.4	-2.0	3.9	7.0	10.2	
Aviva Investors Small Companies Fund*	Distribution	0.6	9.5	13.8	20.5	23.8	21.8	13.8	05/01/1998
	Growth Return	-44.4	-58.0	-34.4	-24.5	-23.2	-16.9	-4.5	
	Total Return	-43.8	-48.5	-20.6	-4.0	0.6	4.9	9.3	
Listed Property									
Aviva Investors Listed Property Fund*	Distribution	0.5	2.0	3.5	5.4	8.6	9.5	9.6	20/01/1998
	Growth Return	-26.8	-51.2	-32.8	-18.5	-16.1	-10.2	-5.1	
	Total Return	-26.3	-49.2	-29.3	-13.1	-7.5	-0.7	4.5	
Fixed Income									
Aviva Investors Income Plus Growth Fund	Distribution	4.5	7.1	7.1	7.0	6.7	6.5	6.1	23/12/1997
	Growth Return	-11.7	-23.4	-14.6	-8.8	-6.3	-3.8	-1.5	
	Total Return	-7.2	-16.3	-7.5	-1.8	0.4	2.7	4.6	

*Closed to new Personal Choice investments.

Disclaimer: All returns are based on exit to exit unit prices for Personal Choice 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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