

Investor Update

12 months to 30 June 2009



Economy

The year began with confirmation that recession had arrived almost everywhere and conditions were as bad as they had been since the Great Depression. Genuine fears of "Great Depression 2" (GD2) abounded. This concern saw enormous dislocation in all asset classes around the turn of the calendar year. Equities and commodities prices fell heavily, currencies swung wildly, credit related securities were trashed and bond markets enjoyed an aggressive "flight to safety" rally down to levels once thought impossible.

Central banks throughout the world have moved aggressively on monetary policy to stave off the effects of the downturn. The US Federal Reserve's fund rate fell to 0-0.25%, and the Reserve Bank of Australia (RBA) slashed rates by 4.25% to 3%, the lowest level seen since the 1960s. Dramatic fiscal policy easing has also taken place, with unprecedented stimulus measures offered to assist the ailing financial system.

Towards financial year end, the pace of the global economic contraction seemed to be slowing as encouraging data began to emerge. Australia, while not immune to the depressed state of the global economy, managed to avoid a technical recession with the release of the March quarter GDP figures. However, this appears to be merely a technicality, as many experts suggest that we are indeed in recession.

Sharemarket

The domestic sharemarket endured its worst financial year in 27 years, with the S&P/ASX 200 Index falling by 24.2%. This was despite a 25% rally over the last four months from its early March lows, illustrating how far the market had fallen into the early months of 2009. Market fundamentals have been tested, and investors spooked by the sharpest global downturn since World War II amidst the near collapse of the world's financial system and the freezing of credit markets.

The pain was felt throughout the globe, with the US S&P 500 dropping 28.2%, Japan's Nikkei 225 slumping 26.1% and the UK's FTSE 100 down 24.5% for the year ending 30 June 2009.

There was a noticeably similar pattern between the Australian market and the US, with both reaching lows in March before staging strong rebounds. The domestic losses for the year were more modest than the US, thanks in part to the banking sector (down 7.2%) holding up reasonably well in the December half in the wake of the severe dislocation in financial markets following Lehman Brothers' demise. Resources underperformed (down 32.2%) the broader market over the year, however, most of these losses occurred in the first four months of the year, after which the sector staged a significant rebound as commodity prices recovered as China's economic stimulus efforts took hold. The defensive Consumer Staples (down 7.1%) and Healthcare (down 2.9%) sectors were the better performed sectors as the local and global economies took a battering, although cyclical stocks began to recover lost ground when markets improved from early March.

Whether the rally which took place from March to June is the start of the long road to recovery or a bear market rally is still to be determined. Either way, the volatile nature of the markets of late is likely to be sustained, at least in the short term

Fixed Interest

To meet ever deepening challenges policy makers everywhere embarked on unprecedented measures. Central banks eased policy hard and fast dropping official interest rates to levels below current life experience. Official interest rates in Japan, the USA and UK are now effectively zero (all 0.50% or lower) and various "quantitative easing" measures have additionally been announced. The European Central Bank (ECB) has trimmed rates to a slim 1%. Fiscal policy was also loosened aggressively with all governments outlining large programs. These will require historically large borrowing programs - namely bond issuance - to fund and deliver.

Thankfully this globally co-ordinated response stabilised the economic freefall such that by the end of the fiscal year so called "green shoots" of economic stabilisation and modest improvement had appeared. Respected leading indicators have edged up somewhat, and both business and consumer sentiment surveys improved. This has marked a welcome end to the severity of the collapse everywhere, and fears that we were all heading for GD2. Having said that, the global economy remains in what is now being labelled "the Great Recession" and unfortunately unemployment rates continue to rise around the globe.

As for global bond markets, the period into calendar year end saw market yields collapse to historic lows as a "flight to quality" gripped the globe. US 10-Year Notes, the global benchmark, fell as low as 2.06% before ending the fiscal year at 3.54%. Non-government corporate (or credit) markets recovered some of the price dislocation associated with the current financial crisis. The broad Barclays Capital Global Aggregate Bond Index (A\$) returned a respectable 9.95%.

Although relatively better performed than the rest of the developed world, Australia has not been immune from the global downturn. Policy here has moved as quickly as the offshore response in an effort to ward off the worst of the slowdown. The RBA has reduced official cash rates 4.25% since last September, the last 1.25% this calendar year. The RBA says further cuts are possible if required. In addition, the Government has announced several fiscal stimulus packages, the latest of which was announced in the May Budget. Like elsewhere the spending and revenue losses forecast will require record levels of bond issuance over the next few years to fund.

The media frenzy as to whether Australia is in so called "technical recession" (two quarters of negative growth) is moot. The domestic economy has already recessed and unfortunately unemployment is likely to trend higher well into next year. Indeed the Government forecasts as much.

As for market moves, offshore influences have been overly important for the domestic fixed income market, with the local market largely mirroring the offshore "flight to quality" into calendar year end. The benchmark UBS Composite Bond Index returned a respectable 10.82%.



Understanding Style

Nick Pashias, Deputy Head of Equities, explains how through its bottom-up approach to stock analysis, Aviva Investors is unconstrained by particular definitions of investment style.

Many investors, advisers and consultants like to pigeon hole fund managers into different groups of fund managers depending on their investment style. Some of the more common groups include value, growth, quant, or sector neutral. Investors however, often have difficulty categorising our bottom-up stock selection approach, which can span both growth and value.

As a fund manager, Aviva Investors is unconstrained by either “value” or “growth” investment styles. Instead, we employ a bottom-up approach to stock analysis and any portfolio bias or outcome is purely a result of our aggregate bottom-up stock picking process.

When doing our research we take a long term view, generally over several years and having due consideration for mean reversion. This can also be described as contrarian investing.

Contrarians simply attempt to be fearful when others are greedy, and to be greedy only when others are fearful because we know that the current mood will eventually turn.

So what do “contrarian investors” look for?

Before we answer this we need to understand the earnings life cycle of a company. The “Earnings Expectations Life Cycle”, first developed by Richard Bernstein, is a simple way of explaining this cycle. We will use this life cycle to illustrate what contrarian investors look for, and how this fits in with the conventional “value” and “growth” investment styles.

The Earnings Expectations Life Cycle, shown below, defines the various stages of investors’ expectations.

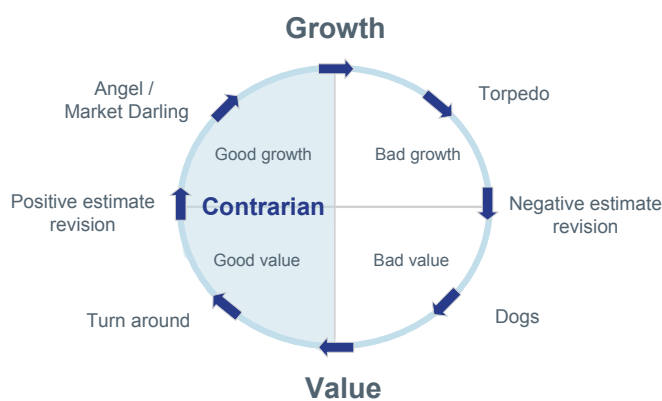


Figure 1: Earnings Expectations Life Cycle
Source: Richard Bernstein

To explain, we will start with growth stocks. These stocks have generally enjoyed good growth for a period of time and have performed well from a share price perspective. Generally, sell side analysts have buy recommendations on these stocks, they are a core part of everyone’s portfolio, and management are viewed as gurus. These stocks are considered indisputably superior, and are often termed “market darlings”. Earnings expectations are very, very high.

From here, the stock “torpedoes”, affected by unexpected problems. This results in the stock losing some love, and it fails to perform on good news and starts to mildly underperform. Sell side analysts start to wind back recommendations and earnings expectations. Many believe the problems are temporary and there is nothing to worry about.

As problems persist, these torpedoing stocks turn to “dog” stocks. Everyone is universally negative towards these stocks, and the problems are thought to be permanent. The share price is sold down on good news, bad news, any news. Management are viewed as incompetent, analysts forecast bottom of the cycle earnings forever, and multi-year underperformance often leads to the stock being neglected. Now expectations are very, very low.

Eventually the stock price stops falling on bad news and starts to perform on good news. More people start doing more research and discover that things aren’t as bad as first thought. Sell recommendations moderate to hold. Price and earnings actually start to perform better, and earnings begin to be upgraded. Before long the stock again becomes a market darling and the cycle is completed.

An example of the Earnings Expectation Life Cycle for the Australian market is Telstra. Back in 1999 to 2000, Telstra was part of the new economy. These companies were going to revolutionise the way business was done and the way consumers bought and sold goods and how they interacted with one another, leading to new found revenue streams and profits. Telstra was a market darling. This was reflected in very high earnings expectations, and also a very high multiple being paid for those earnings, leading to a very strong share price. As illustrated in Figure 2 (Telstra share price in blue and expected earnings per share in grey), both were moving up at the turn of the millennium.



Figure 2: Telstra Corporation share price vs. expected earnings
Source: Factset

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

Unfortunately that did not eventuate as quickly as some had hoped and earnings were gradually wound back and the share price fell for many years. To add to the pain for shareholders the risk of regulation began to plague Telstra, as did the threat of further competition. Over the last few years this has led to earnings expectations falling further and further, and the share price falling to very low levels as the stock moved through the “Torpedo” and “Dog” phases of the cycle. Earnings and the share price began to bottom in 2006. However, Telstra has recently delivered results that have been in line to slightly better than those lowered expectations, and now expectations have actually increased. Consequently, Telstra has performed relatively well over the last year or so, and I believe it is still in the turnaround phase of its earnings life cycle.

It should be noted that not all stocks track the cycle at the same speed and can often do “mini” cycles where they actually go backwards before they go forward.

With the Earnings Expectations Life Cycle in mind, we will now explain the traditional investment styles of value and growth investing, and then provide an indication of what contrarian investors try to do.

What do typical growth and value managers try to do?

Good growth managers are generally in the top left quadrant of the life cycle, often trying to buy stocks with above average growth, and are not overly concerned with the price they pay in terms of multiple. Good growth managers enjoy the sweet spot of the earnings revision cycle.

The risk for growth managers is that they hold on for too long and are torpedoed by an earnings downgrade, which results in not only lower earnings but a lower multiple, and the stock underperforms.

Good value managers on the other hand try to buy stocks that appear cheap on multiples, and are about to turn around or have just recently turned around.

Unfortunately, turnarounds seldom do just that, and stocks can remain “dogs” for a long, long time. The risk for value managers here is that they buy into a stock too early and the stock continues to underperform.

So what do contrarian investors try to do?

Contrarians ideally try to operate in the left hand hemisphere, waiting for stocks to be totally out of fashion, waiting for all the bad news to be in the price and then holding on for the mean reversion. Even when the stocks turn, contrarians hold on.

As mentioned earlier, Aviva Investors are not constrained by strict definitions of value or growth, so remain comfortable holding onto stocks with high growth rates and perceived high valuations so long as we think the upgrade cycle will continue for some time and long term value exists.

Australian Shares Fund* - the fund delivered a return of 11.1% for the six months to June 30, outperforming the benchmark S&P/ASX 200 Accumulation Index of 9.1% by 2.0%, while over the past 12 months the fund outperformed the index by 7.2%.

The main contributors to performance during the financial year were an underweight position in Commonwealth Bank and an overweight position in Foster’s Group. Stocks detracting from performance were overweight positions in Fairfax Media and Rio Tinto.

Elite Opportunities Shares Fund - the fund returned 11.6% for the half year, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 9.1% by 2.5%, while over the past 12 months the fund outperformed the index by 9.6%

Stocks positively contributing to performance for the financial year were overweight positions in Commonwealth Bank and ANZ Banking Group. Not owning Westpac Banking Corporation and Woolworths detracted from performance over the year.

High Growth Shares Fund - the fund returned 13.3% for the six months, outperforming the benchmark S&P/ASX 200 Accumulation Index of 9.1% by 4.2%, while over the past 12 months the fund outperformed the index by 6.4%.

The main contributors to performance for the portfolio during the financial year were overweight positions in Newcrest Mining and BlueScope Steel. Stocks detracting from performance were overweight positions in Rio Tinto and Incitec Pivot.

Listed Property Fund - the fund delivered a return of -9.7% for the six months to June 30, outperforming the benchmark S&P/ASX 200 A-REIT Accumulation Index of -12.9% by 3.2%, while over the past 12 months the fund outperformed the index by 9.5%.

The main contributors to performance over the financial year were underweight positions in Goodman Group and GPT Group. 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 28.4% for the half year, outperforming the benchmark S&P/ASX Small Ordinaries Accumulation Index of 23.2% by 5.2%, while over the past 12 months the fund outperformed the benchmark by 1.5%.

The main contributors to performance over the financial year were not owning Aquarius Platinum and an overweight position in Iress Market Technology. Stocks detracting from performance were overweight positions in Kagara and Mount Gibson Iron.

Income Plus Growth Fund - the fund returned 5.1% for the six months, outperforming the benchmark¹ by 2.1%, while over the past 12 months the fund underperformed the index by 2.3%.

Please note continued volatility in financial markets has impacted a number of credit related securities within the portfolio. Due to the impact these securities have had on the fund, we believe the fund is likely to only achieve a below benchmark return going forward, resulting in investors receiving a low monthly income. As a result, in the best interests of unitholders, the decision was made to terminate the fund effective 3rd July 2009.

To effectively manage the fund wind-up process, we have begun a programme to sell down the portfolio. The liquid portion of the portfolio will be redeemed first, and the proceeds returned to unitholders in late July. The remaining investments in the fund will be managed to maximise returns to unitholders. A second instalment will be paid to unitholders once this process is complete.

[#] All returns are gross of fees. Please refer to page 4 of the Investor Update for a summary returns which are net of fees.

¹ Benchmark is 40% S&P/ASX 200 Industrials Accumulation Index and 60% UBS Australia Composite 0-5 Year Index

Aviva Investors Investment Returns

Performance to 30 June 2009

		6 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	Since Inception % p.a.
Australian Equities						
Australian Shares Fund Inception date: 03/07/1995	Gross Return	11.1	-12.9	-1.1	8.5	10.6
	Benchmark Return	9.1	-20.1	-3.8	6.9	8.5
	Excess Return	2.0	7.2	2.7	1.6	2.1
	Net Return	10.1	-14.6	-3.0	6.4	8.7
Elite Opportunities Fund Inception date: 18/11/2002	Gross Return	11.6	-10.5	1.1	10.5	13.4
	Benchmark Return	9.1	-20.1	-3.8	6.9	8.6
	Excess Return	2.5	9.6	4.9	3.6	4.8
	Net Return	10.8	-11.8	-0.3	8.9	11.9
High Growth Shares Fund Inception date: 07/12/1999	Gross Return	13.3	-13.7	1.3	10.2	13.6
	Benchmark Return	9.1	-20.1	-3.8	6.9	6.9
	Excess Return	4.2	6.4	5.1	3.3	6.7
	Net Return	12.0	-15.1	-0.7	8.0	10.9
Small Companies Fund Inception date: 19/11/1999	Gross Return	28.4	-27.1	1.0	11.8	13.3
	Benchmark Return	23.2	-28.6	-6.4	5.6	5.4
	Excess Return	5.2	1.5	7.4	6.2	7.9
	Net Return	27.1	-28.5	-0.9	9.7	11.2
Listed Property						
Listed Property Fund Inception date: 28/02/1994	Gross Return	-9.7	-32.8	-16.3	-3.4	5.3
	Benchmark Return	-12.9	-42.3	-22.7	-8.4	2.3
	Excess Return	3.2	9.5	6.4	5.0	3.0
	Net Return	-10.6	-34.1	-17.9	-5.2	3.3
Fixed Income						
Income Plus Growth Fund Inception date: 31/03/1998	Gross Return	5.1	-1.7	0.7	4.3	6.6
	Benchmark Return	3.0	0.6	1.7	5.3	6.6
	Excess Return	2.1	-2.3	-1.0	-1.0	0.0
	Net Return	4.2	-3.4	-1.0	2.5	4.8

*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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