

The dramatic falls in investment markets over the past 12 months may have you worried. That's understandable. In this piece we want to present the crucial facts that all investors need to consider before you react to these developments.

WHAT'S HAPPENED?

While the sub-prime/credit crunch crisis really hit a year ago, the roots of the problem can be found in years of poor mortgage lending, especially in the US. Unfortunately, vast amounts of these bad loans were packaged and on-sold to financial institutions around the world. When US house prices started to fall those loans went bad, making the value of these packaged securities fall sharply, draining huge amounts of capital from the global banking system. Falling mortgage-backed asset prices led to the eventual "credit crunch", with financial institutions unwilling to lend to each other.

The credit crunch has impacted financial markets in a number of substantial ways:

- A dysfunctional financial system severely restricts companies from managing the debt on their balance sheets. This can significantly impact a company's performance and outlook, depending on its level of debt;
- Institutional investors are rapidly swinging away from riskier asset classes as they attempt to preserve their precious capital;
- Large volumes of assets that were bought with borrowed funds are being rapidly sold across the globe. This has greatly compounded the falls in the sharemarket.

As a result of the credit crunch, the lack of the availability of credit is causing economic growth around the world to slow quite sharply. Perhaps more importantly, the global banking system faces its own crisis of confidence and as a result, governments are being forced to step in, guaranteeing deposits, flooding the money markets with cash and buying up assets to relieve the pressure in the financial markets.

HOW BAD IS IT?

By historical standards this is a very severe global economic crisis. Major American financial institutions like Bear Stearns, AIG Insurance, Fannie Mae and Freddie Mac have either failed or been effectively taken over by the government. Governments in Europe have also had to bail out large financial companies – such as Northern Rock in the UK and Fortis in Belgium.

In Australia the bear market (a sustained period of falling share prices) is now around one year old. To put that in perspective, since 1970 the average bear market has lasted 14 months. The

average fall in value during a bear market has been around 30% (see the chart overleaf for more historical context).

For the year to end September 2008, the MSCI global sharemarket index is down around 25%, the Australian S&P200 index is down around 27% and the US S&P 500 is down around 24% and have continued to fall in October.

PANIC STATIONS?

While this crisis is significant, we are now at the point where reactions are being driven by sentiment rather than economic reality. In other words, investors are panicking and reacting to the substantially negative media reporting on the outlook for the economy.

We can see this in the wild reactions to the delay in the US government's mortgage buyout package. Closer to home, BHP's share price fell more than 30% in September. Yet BHP is a large, well managed company that generated more than \$15 billion in cash in 2007 and has excellent growth potential because of the demand for raw material from China and India.

IS THERE ANY GOOD NEWS?

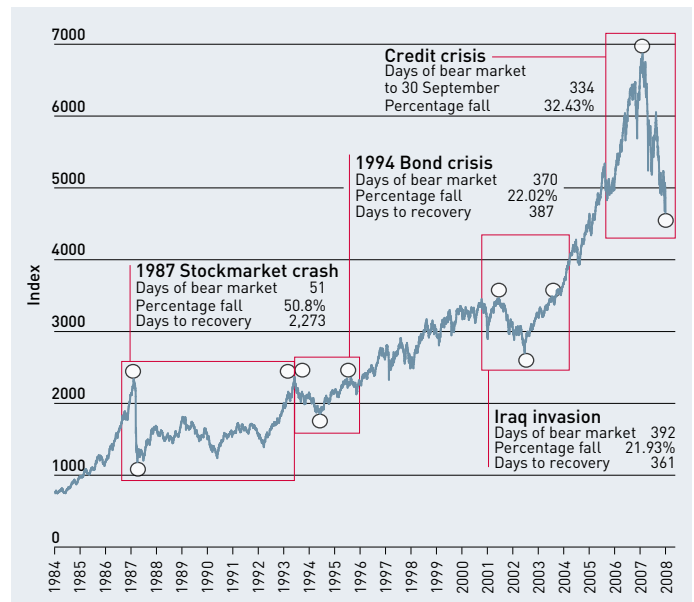
Just as people tend to ignore cautionary tales during the peak of a boom, investors tend to ignore positive news when panic drives markets. However, there are some positive factors you should consider when reviewing your investments;

- Firstly and most importantly, central banks and other regulators around the world are doing all they can to fix the crisis. The US government has launched a Troubled Asset Relief Program (TARP) worth US\$700 billion. It is estimated they have injected another US\$900 billion in cash into money markets to ease the credit crisis. Central banks around the world, in October, have co-ordinated substantial rate cuts with prospects for further falls in the near future. China's central bank has cut rates for the first time in six years. A number of countries, including Australia, have guaranteed deposits or bought shares in financial companies to boost their capital positions. As with many government actions in the economy, these initiatives will take time to take effect. However, if they do restore confidence in the banking system – and they should – we may see a sharp turnaround in sentiment.

- Commodity prices in general have retreated from their highs, easing some of the pressure on inflation.
- Valuations for equities are attractive. The US financial sector is now priced at levels last seen in 1995. Resource stocks (as measured by the Dow Jones Stoxx 600 Basic Resource Index) are now priced at 1999 levels – that is, before the China resources boom began. Cashed up investors are now taking advantage of these valuations. Legendary investor Warren Buffett recently took multi-billion dollar stakes in GE and Goldman Sachs.
- Australian investors are in an excellent position relative to those in other developed economies. We have low unemployment (4.3%), a big government surplus and inflation is under control. Crucially, the banking sector is very strong thanks to the level of regulation and oversight in existence. The Australian financial regulatory system is now being heralded as the optimal model for developed nations as outlined in a recent G30 report. All our major banks are highly profitable and of the 20 AA rated banks in the world, four are in Australia. While the Chinese and Indian economies will not survive the credit crunch unscathed, urbanisation in those two giant countries should continue at speeds sufficient to underpin demand for our resources.

BEAR MARKETS IN AUSTRALIA

Between 1980 and Sep 2008 the Australian sharemarket generated an annual average return of 12.6% including the 87 stockmarket crash, the 1994 bond crisis, the Iraq invasion and the current credit crunch.



Source: Advance Asset Management, 30 September 2008.

HOW TO REACT?

Everyone has their own needs and no single response is right for everyone. However it is important you think about your needs first and the market second.

What does this mean?

- If you initially invested with a time horizon that extends over five years, selling out now may simply crystallise losses. To put this long term argument in perspective consider that the market took six years to recover from the worst fall in the past 30 odd years - the 87 crash. It took just over a year for the market to gain back the losses recorded after the 1994 bond crisis. The post 9/11 instability and the Iraq invasion at the start of this decade lasted nearly three years – but was followed by a boom that saw Australian shares rise by around 141%.
- If you're about to **retire** or currently live off your investment capital, now is the time to consult your adviser. They can assess your overall position, review your risk profile and help you look at alternatives to cashing in all your investments at current low prices.

NOW WHAT?

As mentioned above, everyone has different needs and your response to recent events will depend on your own investment strategy, age and financial needs. If you want more information on what's happening to your money please visit our website at www.advance.com.au or call your financial adviser. If you don't have a financial adviser and wish to speak to one in your local area please call the Financial Planning Association on 1800 337 301 or visit www.fpa.asn.au/FindaPlanner.

Contact Centre: 1800 819 935

Adviser Services: 1300 361 864

advance.com.au

This document has been issued by Advance Asset Management Limited ABN 98 002 538 329 AFSL No. 240902 (Advance). The information provided is of a general nature only and has been prepared without taking into account the objectives, financial situation or needs of any particular person. It is not intended to constitute investment, legal or taxation advice and should not be considered or relied upon as a comprehensive statement on any such matter. Before acting on the information, a person should consider its appropriateness, having regard to their objectives, financial situation and needs. Advance is the responsible entity and issuer of units in the managed funds (Funds) referred to in this publication. Before deciding whether to acquire or to continue to hold an investment in a Fund, investors should obtain and consider the current Product Disclosure Statement for the product, available from your financial adviser or at www.advance.com.au. Past performance is not a reliable indicator of future performance. Information from third parties is believed to be reliable however it has not been independently verified. While the information in this publication is given by Advance in good faith, it does not warrant that it is accurate, reliable, free from error or omission. Subject to any terms implied by statute which cannot be excluded, neither Advance nor any other company in the St George Group and their directors, employees and associates accept any responsibility for errors in, or omissions from the information. Advance is a member of the St.George Group. An investment in a Fund or Super Fund does not represent an investment in, deposit with or other liability of St.George Bank Limited ABN 92 055 513 070 (St.George) or any other member of the St.George Group. It is subject to investment risk, including possible delays in repayment of withdrawal proceeds and loss of income and principal invested. Neither St.George nor any other member of the St.George Group stands behind or otherwise guarantees the capital value of an investment or the performance of a product.

ADVANCE
A member of the St.George Group
INVESTIGATE