

Over the past year, investors have endured one of the most turbulent periods in the modern history of financial markets.

The global financial crisis impacted every part of the financial system and all types of investments as the fear of exposure to sub-prime loans led to the biggest credit contraction and global economic recession since the Great Depression.

While Australian financial markets were extremely volatile, similar to international markets, the Australian financial system and our economy have to date fared better than most other countries.

Some good news is that the unprecedented intervention by governments and regulators around the world appears to have stabilised the financial system and improved confidence in financial markets, which have rallied strongly since early March 2009. However, the sustainability of the recoveries will depend on the impact of the economic downturn on different investments.

### Timeless lessons

Whatever the specific causes of the crisis, it is clear that after years of sustained economic growth, substantial asset price increases and easy access to cheap credit, financial markets generally had become far too complacent about potential risks. It is also clear that regulators and many financial market participants were not fully aware of the risks or the extent that various investments were exposed to those risks.

While it is almost impossible to predict the kind of market shock that occurred or how it would impact the entire world, the global financial crisis has reinforced some timeless lessons about investing.



### ► It's not the short-term swings but the long-term results that matter

While investment valuations can fluctuate greatly based on the current market sentiment and short-term outlook, over the long term, valuations should reflect an investment's actual returns and prospects. Trying to time entry and exit from particular investments to take advantage of short-term market momentum is difficult and can cement losses and result in missing out on future gains.

### ► Risk is just as important as returns

We all invest to make returns but all investments carry risks. It is always important to carefully weigh up potential returns against potential risks. While it can't be eliminated, risk can be mitigated by focusing on quality investments with tangible and sustainable earnings, prudent debt levels, simple and transparent structures, and which are managed by experienced professionals.

### ► **Diversification can reduce risk**

Normal economic cycles and market shocks affect all types of investments, but they affect them in different ways and to different degrees. Diversifying across a range of investments with different characteristics can reduce the impact of one investment's return on your total portfolio.

### ► **If you don't understand it, don't invest in it**

This is one of the big lessons of the crisis for both global financial institutions and individual investors. If you don't understand an investment, you can't understand the risks. Some of the financial instruments that were exposed to sub-prime loans were so complicated, and the underlying assets so obscured, that it will take years to unravel what's left of such assets. It is vital to understand the nature of an investment so you can decide whether it meets your circumstances and objectives. For example, shares can grow wealth over the long term but their value can fluctuate greatly, so they may not be suitable if you want capital stability. Equally, fixed income investments can provide reliable income and capital stability but generally will not provide capital growth over the long term.

### ► **Invest on evidence, not emotion**

Financial markets and the broader economy are subject to the collective sentiment of investors and the general public. These market mood swings can become very powerful, particularly during times of great uncertainty as emotion overtakes the available facts. However, over the long term, the performance of investments should reflect their intrinsic value, risk and returns.

### ► **What you don't invest in is as important as what you do invest in**

Exposure to poor investments can impact your wealth as much as the good investments you are invested in. When investing in a particular market sector, the best way to avoid the poor investments is to apply clear, quality selection criteria and rigorously research specific investments against those criteria.

### ► **Be careful with gearing**

Borrowing money to invest can greatly increase returns in a rising market, but can also increase losses when markets are falling, and therefore needs to be carefully considered. If the investment income doesn't cover the loan interest, then you need to be able to cover the interest payments from other income rather than relying on asset gains to pay loan interest.

### ► **Good advice and planning can be your best investment**

If you don't have a clear financial plan or investment strategy then it can be hard to measure your progress and make decisions about your investments. A professional adviser can be invaluable not just for their knowledge and expertise, but the fact that they can provide an objective perspective that can help keep you on track to achieve your goals, particularly during turbulent times.

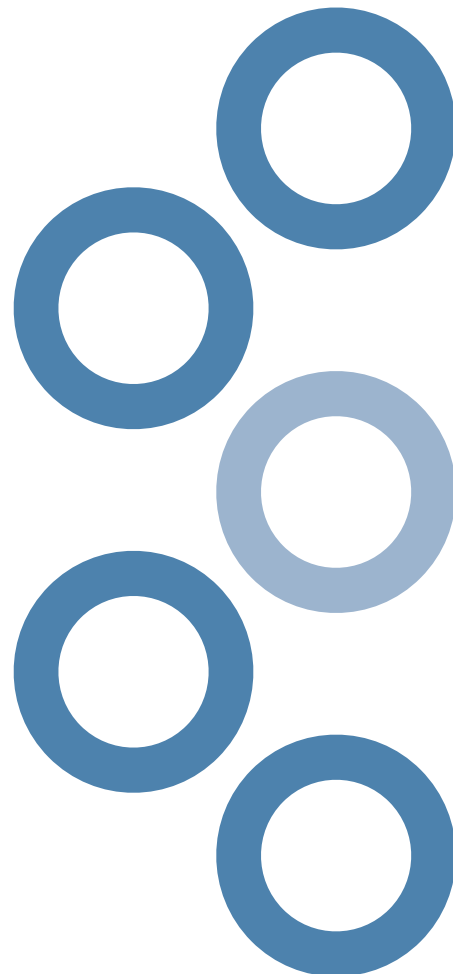
## **How we manage your money**

We aim to provide clear and concise information about the investments we offer so you can make informed choices about the appropriate investment strategy for you. In particular we aim to ensure you are able to understand the nature of different types of investments, the potential risks and potential returns over different timeframes.

Perpetual's investment team makes active investment decisions based on our intensive fundamental analysis of an investment's intrinsic quality, value and risk. In stocks, we focus on quality businesses with sustainable earnings, strong balance sheets and resilience through the economic cycle. In fixed income we focus on providing regular income, liquidity and capital stability.

We also offer a range of investments managed by other fund managers who have been carefully selected for their specialist skills, investment style and track record. We aim to provide a broad choice of quality investments with particular characteristics to meet our clients' needs.

Perpetual has been managing and administering the assets of generations of Australians since 1886. This has given us the experience to work through different market cycles to grow and protect our clients' wealth over the long term.



## The investment year in review

The global financial crisis has not just been a cyclical bear market after a long-run bull market. It has been a real shock to the global financial system and investors everywhere.

At its worst point following the collapse of US investment bank Lehman Brothers in September 2008, it became a crisis of confidence that affected every part of the global financial system.

The problem began with rising defaults on poorly secured sub-prime home loans in the US, as house prices fell. However, it spiralled out of control as many US and European financial institutions had become deeply exposed to complex investment structures backed by these sub-prime loans.

The resulting crisis caused the greatest credit contraction since the Great Depression. It wiped out some of the oldest Wall Street investment banks and caused the whole or part-nationalisation of some of the largest financial institutions in the US and Europe. It forced governments to underpin financial markets with guarantees and print unprecedented amounts of money to keep credit flowing and fund economic stimulus programs.

Fortunately, Australian financial institutions and indeed the Australian economy, through a combination of good management, good regulation and some good fortune, appear to have avoided the worst of the global crisis. However, the economic recovery is likely to be long and protracted as business and individuals continue to reduce debt levels. This means consumers will spend less and remain wary of the risks associated with high levels of borrowing.

### Asset class overview

#### ○○○ Australian equities

Australian shares, as measured by the S&P/ASX Accumulation 300 Index, declined 20.3% over the 2008/2009 financial year. Industrial shares, as measured by the S&P/ASX 300 Industrials Accumulation Index, fell 14.5% over the same period.

The scarcity and high cost of credit following the collapse of US investment bank Lehman Brothers in September 2008 prompted widespread share price falls, especially for heavily indebted stocks. However, following the low point for the year in early March 2009, the worst fears for the global financial system seem to have abated and attention has turned to the economic outlook. When positive signs appeared, markets rallied strongly to the end of the financial year.

Industrial stocks outperformed resource stocks over the 12 months. The best performing sectors over the year were the traditionally defensive sectors of healthcare (+0.4%) and consumer staples (-2.9%), along with financials (-6.2%) which have rallied sharply since March. The worst performing sectors were property trusts (-42.1%), materials (-33.7%) and energy (-23%).

#### ○○○ International equities

Global shares, as measured by the MSCI World (ex Australia) Net Return Index, declined 16.2% in 2008/2009 in Australian dollar terms. Asia Pacific ex Japan (-3.3%) was the best performing region, and the weakest were the UK (-21.9%) and Europe (-21.3%). Globally, defensive sectors including consumer staples (+2.2%) and healthcare (+1.4%) outperformed materials (-33.7%) and energy (-28.4%). The Australian dollar depreciated 15.8% which helped unhedged Australian investments in international markets.

After hitting a low for the year in early March 2009, global markets rallied strongly on the belief that government intervention had restored stability to the financial system and that the global recession might not be as deep and protracted as feared. For the year ahead, share valuations will be greatly influenced by any solid evidence of the start or stalling of a global economic recovery.

#### ○○○ Listed property

The Australian listed property sector, as measured by the S&P/ASX A-REIT 300 Accumulation Index, declined 42.1% in 2008/2009. The sector was one of the hardest hit by the global crisis, particularly those companies and trusts that were heavily geared and whose profitability was reliant on access to cheap debt and increasing asset prices.

Many companies and trusts were forced to undertake large capital raisings to repair their balance sheets and reduce debt. As the financial system stabilised and the prospects for an economic recovery emerged after March, the companies and trusts with strong and sustainable business models rallied quite strongly. Overall, the sector is returning to the basics of investing in properties for their rental yields.

#### ○○○ Fixed income

Fixed income investments, as measured by the UBS Composite Bond All Maturities Month End Index, returned 10.8% for the year, however returns varied greatly for different fixed interest securities depending on how they were impacted by the credit crisis. The central feature of the financial crisis was the credit contraction that, at its worst, even saw major banks wary of lending to each other, stopping the money flows that are the lifeblood of the global economy. Credit margins required by lenders and investors dramatically expanded, prices fell and markets for the most complex and high risk securities essentially froze. At the same time there was a flight to the safety of government bonds. Following the massive government interventions to support the financial system and improve liquidity, credit markets began to thaw late in the financial year.

#### ○○○ Mortgages

Considering the turmoil in short-term money markets, commercial mortgages provided a safe haven and reliable income for investors. Even though interest rates were falling during the year, mortgage returns relative to cash rates increased as credit availability tightened through the credit crunch. To keep credit markets functioning, the Federal Government introduced a guarantee on financial institution deposits, which attracted money away from mortgage funds as investors sought the safety of the guarantee during the crisis. However, as the global financial system stabilised in the second half of the year, credit markets started moving again and lower interest rates provided support for property markets.

#### ○○○ Cash

Cash provided shelter from the broader market turmoil, however returns declined over the year as the Reserve Bank of Australia reduced its official cash rate from 7.3% at the start of the financial year to 3.0% at the end. Cash returns for the full year were 5.5%, as measured by the UBSW Bank Bill All Maturities Daily Index. It is likely that interest rates will remain at their relatively low levels for at least the next year and future rate rises will depend on the strength of economic recovery.

## Find out more about investing

We have a range of educational materials available on our website, including:

- Articles about current issues such as our Federal Budget update
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- 'Real Value' educational booklets



- 'Guide to investing' flyers



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