QUEST

# QUARTERLY REPORT

## SEPTEMBER 2011

John Citizen Family Superfund

# QUARTERLY REPORT

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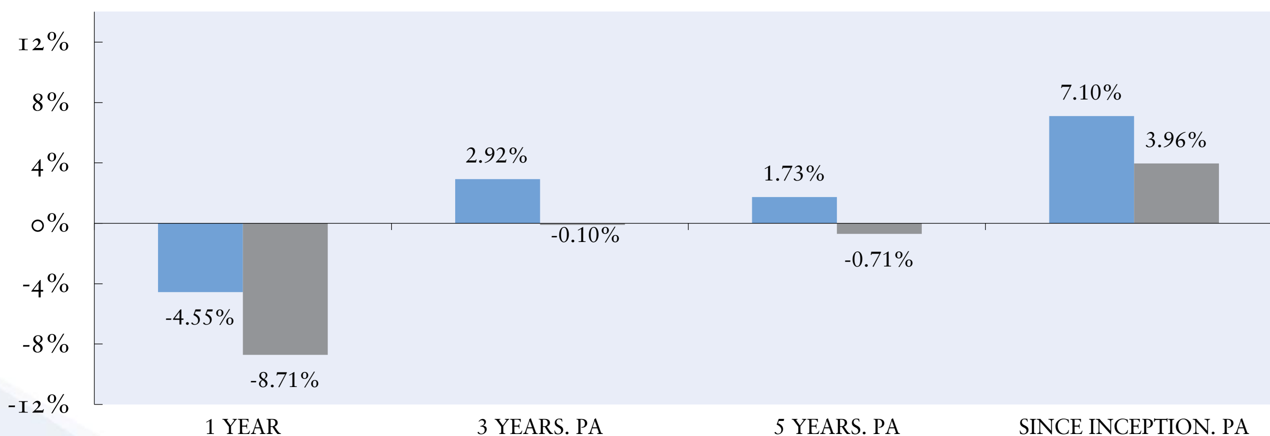
| Mr John Citizen<br><br>Account Name: John Citizen | 123 ABC Street<br>Sydney NSW 2000 |

| PORTFOLIO MOVEMENT – 30 –SEPT-11 | |
|---|---|
| PREVIOUS MARKET VALUE | |
| CONTRIBUTIONS DURING QUARTER | |
| PORTFOLIO MOVEMENT* | |
| MARKET VALUE | |

| | |
|---|---|
| YOUR PORTFOLIO PERFORMANCE FOR THE QUARTER* | |
| MARKET RETURN (S&P / ASX 300 ACCUMULATION INDEX) | -11.65% |

*Includes fees for the quarter




** The portfolio returns quoted above represent the return achieved if invested in the Quest portfolio since inception (February 2005). Individual returns will differ for investors that made an initial investment after this inception date or where additional investments or redemptions have been made. Quest returns are net of fees. Past performance is not a reliable indicator of future performance.

# MARKET ACTIVITY

## THE SEPTEMBER QUARTER WAS DOMINATED BY CONCERNS ABOUT GLOBAL DEBT. WHILE THE US ECONOMY CONTINUES TO TREAD WATER, THE SPOTLIGHT SHIFTED BACK TO EUROPE SOVEREIGN DEBT. THE AUSTRALIAN DOLLAR FINALLY ROLLED OVER. THE QUEST PORTFOLIO SIGNIFICANTLY OUTPERFORMED THE MARKET DURING THE QUARTER.

The most striking thing about the September quarter was the constant flow of bad news. The US economy has failed to deliver any significant improvement, Europe is debt laden and the politicians have not yet implemented a sensible plan. China has seen some slowdown in the property development market which has triggered a strong reaction in resource stocks.

The level of pessimism has now reached a level where we are spending a lot more time on potential buy opportunities than potential sells.

The Australian market slumped 11.6% over the quarter and The Dow Jones was down 12.1%. The Quest portfolio fared somewhat better falling 8.5%, outperforming the market by a good margin.

The major corporate event during the quarter was the takeover bid for Foster's Group. The initial bid of $4.76 per share was popped to $5.53 and the deal was accepted by Fosters' Directors. SAB Miller is the buyer and is based in London so its goodbye to another Australian household brand name. SAB Miller is one of the worlds' largest brewers with operations in 75 countries. In 2011, the company sold 21.7 billion litres of beer globally.

The Quest portfolio has been set in a more defensive mode which contributed to its outperformance. We saw the market heading down due to the European debt pressures and removed a number of smaller stocks from the portfolio, particularly resource names, replacing them with more conservative, higher yielding stocks. As a result cash levels were lifted.

Macarthur Coal and Sundance Resources both received take-over bids in the quarter. We have now had three takeovers for our resource holdings this year, the other being Equinox in April.

Macarthur was bid for by the American coal giant Peabody Inc. at $16 which was a terrific premium to the $11 price tag back in July. We sold more than half our holding but retained some in case of a higher bid, which we see as possible but not likely.

Sundance was bid for by Chinese investor Hanlong. The 50 cents bid was well above our 35 cent entry price; we took the profit.

Profits were also taken on Seek. Hillgrove Resources was sold at break even. RIO, Sims Metal Management and Transfield were sold at a loss. We also took up our entitlement to the Gindalbie Metals rights issue.

During the quarter, we added Australian Stock Exchange (ASX), Alacer Gold, Brickworks,

Lend Lease, Santos and Stockland to the portfolio.

ASX has settled back to a sensible level post the failed takeover bid from Singapore Stock Exchange earlier this year. In our view the market has been overly concerned about the impact of new competitor “Chi-X” in October that may actually boost volumes as has been the case overseas. The stock has multiple income streams, good cost control, a strong balance sheet and management team. ASX also delivers a solid 6.6 % franked yield.

Alacer Gold is a little known company but happens to be Australia’s second largest gold producer. Alacer (previously Avoca Resources) was merged with Anatolia in February 2011 and expects to produce 280,000 ounces of gold from mines in Turkey and Western Australia in calendar 2011. Australian mines include Higginsville, HBJ and the intriguingly named Frogs Legs near Kalgoorlie. In Turkey, the Copler mine is the value driver producing over 100,000 ounces for the first time this year. We will be visiting the Turkish operations in October 2011.

Brickworks was added before the annual result after a dramatic share price slide due to the parlous state of the Australian construction industry. The company has an interesting balance sheet that involves a cross shareholding with Soul Pattinson, which in turn owns 60% of the successful New Hope Coal. Brickworks also owns acres of western Sydney land as well as the core brick making operation.

Brickworks is a good old fashioned, conservatively run toiler that produces great results. Our investment was aimed at the potential for management to release value from the balance sheet by means of some capital initiatives. This occurred in October but not as we had expected. The Soul Pattinson Board have effectively offered their interest in New Hope Coal for sale via a data room sale process. This may or may not lead to a sale but it has caused a sharp uplift in the Brickworks share price. We await further developments in relation to New Hope Coal where there is undoubtedly offshore interest. The sticking point will come down to price.

Lend Lease fell back into buying range in July. The company is dispensing many of its offshore interests and in some sense is “coming home”. Lend Lease purchased Valemus (previously known as Bilfinger Berger) in December 2010 for $960 million. Valemus owns Abigroup and Baulderstone which fits nicely with the existing Bovis construction business. This move into construction comes as Leighton Holdings struggles with performance issues. Lend Lease has become a lot more focussed over the last year. Management has established Return on Equity as a key metric and the results are starting to improve. We continue to accumulate the stock in the current weakness.

Santos was added to the portfolio during the quarter. It is a quality, diversified energy producer with production from the Cooper Basin, a number of fields in North Western Australia, 13% of Papua New Guinea LNG, 30% of the Gladstone LNG Project and a large exploration portfolio. First gas from Santos Gladstone Project is planned for 2015. Santos has, in our view, fallen too far. Our target price is well above the current price of $11.

The Stockland share price has been falling for nearly four years. The apparently defensive property stock has suffered at the hands of a tough Australian housing market, a poor apartment market and a number of acquisitions that have been less than successful. Management have not kicked many recent goals and the accounts indicate that they are very well paid. We are looking for change from Stockland on a number of fronts. Shortly after our purchase, the company announced a share buyback which has halted the decline. Stockland now provides a yield of over 7% and is trading at more than a 20% discount to the net tangible assets. We can’t see the stock

visiting a recent low of $2.62 again. This is no greyhound but we believe the risk to now be mispriced.

Further to the property trust theme, GPT was sold and repurchased during the quarter. We initially bought our stake in GPT when Stockland sold their strategic holding in GPT last year at a discount. GPT has proved to be a great little earner for Quest; we like the composed style of CEO Michael Cameron and his no nonsense approach to business. During the quarter, GPT hit our price target and we realised a solid gain. Shortly after, the market collapsed and we bought the position back again around $3. Net tangible assets are stated at $3.64 and the yield is above 5%. GPT has recently streamlined operations with the sale of offshore assets in favour of shopping centre development in Australia. At the time of writing, GPT is well on the way back to our target price.

The largest allocation of funds in our portfolio is in banks. Banks are weak at the moment due to the problems in Europe. Fundamentally we believe Australian banks are cheap with excellent post tax yields. While they may get cheaper again in the current market without resolution in Europe, we are sticking with our valuation principles and anticipate better performance ahead.

# OUTLOOK

AS DISCUSSED IN OUR LAST QUARTERLY, THERE REMAIN SOME BIG LINGERING ISSUES IN THE WORLD'S ECONOMIES THAT WILL EVENTUALLY DEMAND ATTENTION. WE SAW A GOOD DOSE OF REALITY ON THIS FRONT IN RECENT MONTHS WITH AN UNNERVING RIDE IN THE STOCKMARKET. PROGRESS IS NOW BEING MADE IN TACKLING THE PROBLEMS IN EUROPE AND THE AUSTRALIAN MARKET IS UNDOUBTEDLY CHEAP. THE SIGNS ARE GOOD FOR STRONG FUTURE GAINS FOR PATIENT INVESTORS.

The huge day-to-day swings in the market of recent weeks betray the fact that investors really don't know which way to turn. The European crisis is large and complex and investors can't decide whether we are sitting on the brink of GFC II or are about to see an enormous rally on the back of a solution in Europe. The prospects of either scenario happening are being reassessed almost on an hourly basis and the market can even move violently on a journalist's internet blog.

We discussed many of the troubling issues confronting financial markets in our last quarterly report. The most pressing being the need for some real (read painful) decisions to address the European sovereign debt crisis.

Although certainly not yet resolved, policy makers are now being dragged towards some meaningful action in Europe. Without wanting to go over old ground the following is a quick summary of our thoughts:

## EUROPE

During the quarter, markets lost faith in the notion that the sovereign debt crisis could be managed by policy decisions alone.

Previous bailout packages were not big enough and merely transferred the problem from the debt holders to the State and its citizens. Eventually debt has to be repaid and under any bailout scenario the tax payer bears the greatest burden.

Quite rightly, the markets and the public (especially the German voter) began to revolt and are now demanding more of the pain be shared with those actually holding the impaired sovereign debt. European (and other) banks with significant exposure to troubled sovereigns (Greece, Portugal, Ireland, Italy and Spain) are most at risk. Given the size and importance of some of these banks the feared knock on effect is that financial chaos spreads throughout the world. The signs of this are already evident in volatile equity markets and the drying up of credit as higher interest rates are demanded by banks to lend to each other.

We have argued for some time that further bailouts are not enough. European ministers are finally now (quite rightly in our view) calling for the need to recapitalise the European banking system so that banks can withstand the impact of proper revaluations of impaired assets. This is an encouraging sign. Given the speed of developments, this may well have progressed further following the drafting of this report.

It has been our view that until the banks are properly capitalised, the problem will continue to fester. This cannot be done simply with the wave of a magic wand as the potential dollars involved are huge. The money has to come from somewhere and we don't underestimate the political, financial and sovereign challenges. The strong rally in early October suggests the market is assuming this is almost a done deal. We think it might be a little tougher than that with potential for a further crisis required to get those making the decisions actually across the line.

The end result could see the partial or complete nationalisation of some European banks whilst others are left to fail. Their existing bank shareholders will be the big losers and the process would impact other investors as enormous equity raisings drain cash from the market. Once the decision is made by one or a number of banks to go down this path, it is likely there will be a rush to join in, as being left behind could mean failure.

With some form of recapitalisation having taken place, the harsh conditions constraining the Euro zone would be eased allowing the economies (and markets) making up the Euro to stabilise. As noted, this would be seen as a cathartic event resulting in large and probably sustained rebounds in world markets.

There are of course a myriad of complicating factors unique to Europe. Perhaps the most challenging is the fate of the single Euro currency. The experiment seems to have failed and an eventual restructuring of the currency appears likely to us. Germany or even France might initiate this by leaving the Euro. Currencies could once again act as a natural stabiliser allowing revaluation to occur where it is needed most. This is a complex question and will not be resolved easily.

The additional unknown is the impact on the enormous credit derivative markets; the CDS (Credit Default Swap) market being the most notable. There is a strong incentive for the workout process to remain orderly in order to preserve these markets as the alternative is financial contagion.

## UNITED STATES

We have been on the ground in the US in recent weeks. It is clear that politicians are now firmly in (early) election mode. The debt ceiling debacle in July saw both parties almost come together to agree a so called "grand bargain". This could have delivered bipartisan support for some sensible fiscal decisions which would have been a significant step forward. Having failed that, the Democrats and Republicans moved strongly back to their traditional left and right corners to shore up support from their voter base as they eye a 2012 election.

Data out of the US continues to disappoint and there is a chance that the world's biggest economy slips back into recession. This combined with the European mess is causing economists everywhere to revise down their estimates for world GDP growth over the next few years. Goldman Sachs are currently estimating that Europe will only grow by 0.1% in 2012 (down from 1.3%) and that the US will grow by 1.4% (down from 2.0%).

The US Federal Reserve continues to be watched closely by the market. The Fed is searching its shed for more monetary tools to help support the US economy. The reality is that there isn't a lot more the Fed can do as US Treasury yields are already at record lows. Further fiscal stimulus would clearly help the US economy but given the state of the government balance sheet this is a tricky proposition.

Contrasting this is our recent experience "on the street" in the US which is not as dire as you might expect. There appears to be a general feeling that the economy might have bottomed. Whilst there are few signs that the economy is likely to take off anytime soon, slow steady improvement might be the way it plays out. With a large chunk of earnings from US-listed

companies now being generated from outside of the US (and benefiting from a falling US dollar), valuations look reasonable.

It is also clear to us that if things materially worsen and the US does veer into recession we would see further significant action. The US has previously shown that it will do whatever it takes to support its economy. This could include further fiscal stimulus despite a stretched balance sheet. As inflation recedes and if growth slows further in the US it possible that fears of deflation again re-surface. In this scenario, we would expect QEIII to be considered.

## CHINA

The optimism regarding China has moderated significantly in recent weeks, with Asian construction stocks seeing heavy selling.

Fixed Asset Investment (FAI) has been running at massive levels for a number of years and the Chinese National Audit Office recently undertook a study of whether the funding of various projects was sustainable. China's funding structure is similar to Australia's where the revenue/reserves are with the national government and the states/provinces carry the debt. This government body found that 11.2% of loans (RMB560 billion!) to Local Government Finance Vehicles (known as LGFV's) were 'substandard'. Others dispute the 11%. In early September, one province's own Provincial Audit Office found 85% of their LGFV's had defaulted on a debt obligation in 2010. The size of the problem could be enough to offset all of China's GDP growth this year.

The 'invisible hand' of the central government may well seek to push this problem out into the future – just like the Europeans have been doing. The significance for Australia is that China is currently consuming a huge proportion of Australia's – and the world's - raw materials. We see this issue as behind the recent weakness in the Australian dollar.

So what do we do with this? Our analysis has focused on each raw material's cost curve. For instance, the most marginal producer of iron ore currently is a Chinese mine selling locally to Chinese steel mills. As their ore grade is very low, they need approximately $US150/tonne to justify production. This is well north of 'marginal' Australian mines at $US100/tonne including freight. BHP and RIO produce at less than $50/tonne.

The key however is to analyse the shape of the cost curve. If demand falls 10%, the marginal mine cost drops from $US150/tonne to approximately $120/tonne. Whilst profit falls dramatically in a pull back, volume falls are much less likely for Australian producers given their strong position on the cost curve.

An easing in commodity prices is normal cyclical behaviour. However, when China is consuming 70% of the world's iron ore, any slowing becomes a major issue. Particularly in the schizophrenic market that we work in today. We see the recent Chinese slow down as inevitable but also an opportunity to move back into good resource stocks which have been pummelled.

## AUSTRALIA

After falling for six months in a row due primarily to global debt concerns, the local market has become cheap. High yields and low corporate debt levels add to the attraction. Buybacks are popular, with six Quest holdings currently buying back their own shares.

The RBA has been managing monetary policy to cope with an unprecedented high in Australia's Terms of Trade. It now appears to be reconsidering its restrictive policy as world growth slows and the pain increases in the Australian economy.

With the RBA cash rate at a relatively high 4.75% and the resultant high Australian dollar, industrial companies have been poor performers. On average, the earnings from

these companies have been falling for last four years. Some of these businesses will fare much better with a lower dollar and lower interest rates. Quest has been reviewing this group for potential further investment.

Prices are undoubtedly cheap in Australia. At current levels, the market is implying that many Australian companies will never grow their earnings again.

We believe investors will make good money over the next three to five years by investing now.

Timing markets is always difficult and the question remains whether lower prices might create a better entry point in coming months. Whilst that is hard to pick exactly, it appears that the conditions for better future stock prices are now emerging. With the European crisis now finally being addressed head-on and stock prices in Australia at low levels, we are looking to capture some sizeable gains for our investors in the years ahead.

# STOCK FOCUS

QUEST HAS A STRUCTURED INVESTMENT PROCESS WHERE WE CONSIDER BOTH QUALITATIVE AND QUANTITATIVE FACTORS. AS AN INSIGHT INTO HOW WE THINK ABOUT INVESTING, WE LIST BELOW FOUR INTERESTING STOCKS AND WHY WE OWN THEM.

## TRANSURBAN GROUP LIMITED

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|---|---|
| STOCK CODE | TCL |
| CURRENT PRICE | $5.30 |
| CAPITALISATION | $7.7 BILLION |
| Q STOCK RATING | A |
| QUEST VALUATION | $5.80 |

Ranked at 26 by size in the Australian market, Transurban is significant portfolio position for Quest. The company owns the concessions for CityLink Melbourne tollroad, the Lane Cove Tunnel, the M2, M5 and the Westlink M7 in Sydney. In the US, the Pocahontas 895 and the Capital Beltway express lanes in Virginia US make up the offshore portfolio.

Transurban is considered a defensive stock; the flow of cars up and down roads has little to do with overall economic activity and sentiment. Volume tends to grow over time. It should be noted that The Sydney Harbour Bridge is still ramping up volumes after 79 years!

The concession agreements have an inflation adjusted toll charge which is why the tolls regularly rise. Road improvements, usually widening and the addition of new ramps, can also add to capacity.

The company scores well in our qualitative "Q- Stocks" assessment particularly amongst the business sustainability tests.

Pricing power and control over customers is particularly strong as the customers have little alternative! Management scores are also above average.

The company was subject to an all cash takeover bid from a consortium of Canadian Pension funds at $5.57 per share in May 2010. The bid was successfully repelled by the Board who followed with a fund raising and purchase of the Lane Cove Tunnel. The Quest investment was made shortly after while the stock price was struggling.

The company has transformed its' management style over the last couple of years with major cost cutting initiatives that included the abandonment of some impressive office space with vast views in the Rialto Tower in Melbourne. The company now has more appropriate offices in a more affordable surrounds.

Transurban has performed very well amidst recent market turbulence and with a yield in excess of 5% with further growth expected in outlying years, we anticipate further gains from this stock.

## DORAY MINERALS LIMITED

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| STOCK CODE | DRM |
| CURRENT PRICE | $1.18 |
| CAPITALISATION | $75 MILLION |
| Q STOCK RATING | C |
| QUEST VALUATION | $1.67 |

Doray was listed in February 2010. The company is a gold explorer with a range of properties in the Murchison region north of Meekatharra in Western Australia. The main area of interest is the Andy Well project where an extensive drilling program is establishing the size of a deposit known as the Wilbur lode. The company has released a series of drilling results in recent weeks which establish that the deposit is open at depth and along strike with some narrow but very high grade sections. While existing JORC resource is currently only 174,000 oz gold, we expect an updated JORC resource of above 300,000 oz by Christmas.

New high grade gold deposits are rare in Australia with a lot of exploration now focussed overseas. The Wilbur Lode sits very close to a highway and has power and water access. The risks inherent in an Australian development of this type are easier to understand compared to an offshore explorer. We consider that Doray, despite a current lack of critical mass, will be a solid growth story during 2012. There is also the possibility that Doray's ground may be attractive to another player seeking a high grade deposit.

Being an explorer, the stock scores only a "C' rating. The exploration program sees cash flowing out with no offsetting revenue. Explorers inevitably return to the markets to get more cash.

The ground is however very promising with some spectacularly high grades. We have got to know the management team and are confident that a significant drilling campaign will define the resource over the next year. The next step is an efficient mine plan followed by plant construction and production in 2013.

## WHITEHAVEN COAL LIMITED

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|---|---|
| STOCK CODE | WHC |
| CURRENT PRICE | $5.73 |
| CAPITALISATION | $2.8 BILLION |
| Q STOCK RATING | C |
| QUEST VALUATION | $8.00 |

In order to own a coal stock you need confidence in management, a positive view on coal demand and a quality deposit with appropriate infrastructure. The Whitehaven team have a long record in coal. In 2006 the same management team built up Excel Coal before a takeover bid by Peabody Coal Inc. shifted ownership offshore. The same management team has been building up the NSW assets of Whitehaven for some years now.

The assets are in the Gunnedah Basin in NSW so distance and port capacity are variables that need to be considered. There is no point having good coal if you can't send it to the clients. In 2011, Whitehaven exported 4.5 million tonnes of coal up from 3.7 million tonnes in 2010. The 2012 operational budget is for 7 million tonnes while 15 million tonnes p.a. is being targeted from 2015.

Resource stocks usually score only "C" ratings under our Stage 1 assessment due to the uncertainty of resource prices, the capital costs and the time involved in development. In this case these factors are offset by an experienced management team and an undervalued share price.

Coal type will be roughly 50/50 thermal/metallurgical coal by 2016. While the mood is negative for anything mining related at the moment, our view is that this stock gets more compelling as the price falls.

It was only months ago that our Macarthur Coal investment was trading listlessly at $10.50. Macarthur is currently under takeover and trading at nearly $16, so our experience tells us that strategically valuable investments will find their price over time. We will ride out the current cycle on this one.

## OIL SEARCH LIMITED

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|---|---|
| STOCK CODE | OSH |
| CURRENT PRICE | $5.93 |
| CAPITALISATION | $7.8 BILLION |
| Q STOCK RATING | C |
| QUEST VALUATION | $8.00 |

Oil Search owns 29% of the Papua New Guinea Liquified Natural Gas Project which is operated and managed by Exxon Mobil. This is a $15 billion project that commenced in 2010 and plans first gas from the New Guinea highlands in 2014.

This is a massive project, involving construction of onshore and offshore pipelines, gas plants, wharves, housing, airfields and other infrastructure. The gas will be tapped in the highlands at altitudes of up to 3,000 metres before travelling 450 km by pipeline to LNG production trains in Port Moresby. The gas is then super chilled into liquid at -160 degrees Celsius which reduces the volume by a factor of 600 to allow shipping. LNG shipping globally has now recorded over 30,000 voyages without mishap.

Gas has been contracted to Asian end-users with the recent Japanese tsunami disaster increasing the attractiveness of LNG as an alternative energy source to nuclear.

The project is not without risk given the multitude of tribal issues that exist in PNG in relation to land ownership as well as social issues. There are over 200 separate dialects in PNG. The population will however benefit from the employment of thousands of labourers and the development of skills within communities. Medical facilities amongst other things are taking a leap forward.

We are attracted to this project due to its advanced stage of construction (relative to other LNG plays), the scale of the project and the leverage that exists by scaling up the project. Two LNG trains are currently under construction and this may be expanded to three or four trains over time which will increase the returns achieved on the total capital invested.

While construction continues, there will be periods when the stock falls out of favour. The stock is currently weak due to a sluggish oil price. Our valuations are based on the long term value of the project and we believe this stock will deliver over our three to five year time horizon.

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