QUEST

Quest Asset Partners

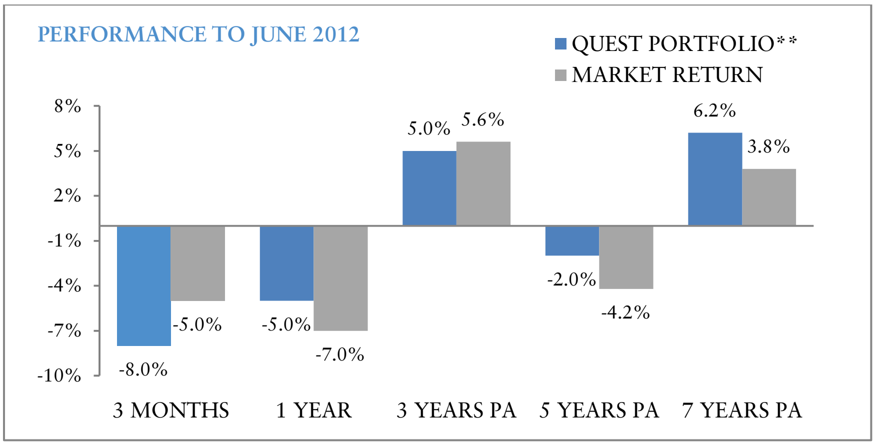
Quarterly Report 2012

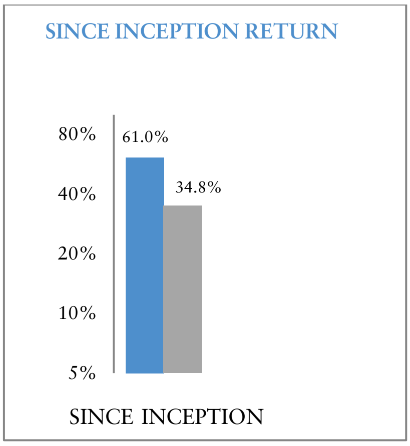
QUARTERLY REPORT
JUNE 2012

Mr John Citizen	123 ABC Street, Sydney NSW 2000
Account Name: : Mr John Citizen	

PORTFOLIO MOVEMENT – 30- JUNE-12	
PREVIOUS MARKET VALUE 31-MAR-12	$0.00
CONTRIBUTIONS DURING QUARTER	$0.00
PORTFOLIO MOVEMENT*	$0.00
MARKET VALUE	$0.00
YOUR PORTFOLIO PERFORMANCE FOR THE QUARTER*	-8.04%
MARKET RETURN (S&P / ASX 300 ACCUMULATION INDEX)	-5.02%

*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.

PORTFOLIO ACTIVITY

THE JUNE QUARTER DELIVERED A NEGATIVE RETURN AFTER A SOLID MARCH QUARTER.

The S&P/ASX 300 Index fell by 5.0% in the quarter while the Quest portfolio was down approximately 8.0% after fees. Our investments in gold stocks performed poorly during the quarter impacting our portfolio return.

Returns were generally weaker in international equity markets: the US S&P500 was down 3.3%, the UK FTSE fell 3.4% while the Japanese Nikkei fell 10.7%.

Over the longer period of the full fiscal year, the Quest portfolio returned -5.0% after fees compared to a market return of -7.0%. Contributing to this were the strong returns made on two takeovers that were completed during the year and good performances from some of the larger industrial stocks held in the portfolio.

In the March quarterly we noted that a good result was delivered despite a volatile economic background. The situation was reversed in June with continuing economic instability in Europe eroding investor confidence.

Australian interest rates were lowered twice in the quarter; 25 basis points in May and 50 basis points in June. While the first cut was expected, the second was greater than expectations. There have now been four interest rate cuts since October 2011. The June cut was in response to perceived weakness in the local economy. However, only days later, the Australian GDP for the March quarter came in at 1.3%, well ahead of expectations.

We are unlikely to see another cut until the Reserve Bank can sharpen its view on what is really happening in the economy.

The perception on the street is that the economy is deteriorating and business leaders warn of harsher conditions. At the same time, political leaders are spruiking the strength of the economy given the strength of reported GDP figures. Our view is that economic figures are too optimistic and that business confidence is very low; the politicians should be preparing for deterioration in coming months. Until then, rates will be on hold.

While the market was generally weaker, Quest saw three stocks approach or hit our target price. GPT Group, for the second time, delivered an excellent low risk return and was sold at prices above $3.20. The Transurban position has been reduced with sales at good prices put into cash. Our CSL holding has also been trimmed however we still hold a significant position. CSL has been in our portfolios since inception and has also been the subject of many paragraphs in past quarterly reports. We regard this stock highly with an “A” grade rating under our Q Stock rating system. Share price performance has been excellent over the last six months as the business continues to deliver.

There were three stocks added to the portfolio during the quarter: Origin Energy, Wesfarmers and ANZ.

Origin has been in our portfolio twice before; in 2006 and 2008. In January 2010, Origin peaked at $17 before slowly rolling down to the recent price of around $13. Origin is on a long-term journey to build Australia's biggest and best energy retailer. Acquisitions of Integral and Country Energy in NSW occurred in 2011. Origin are progressively building integrated fuel and generation assets to match the customer load. Concern about congestion in LNG development in QLD has weighed on their share price and provided an opportunity for investors.

Wesfarmers own a range of assets including Coles, Bunnings, Liquorland, K Mart, Target and the Curragh coal mine in Queensland's Bowen Basin. A recent fall in the share price due to weaker coal prices allowed us to buy below our target valuation.

ANZ returned to the portfolio during this quarter. In our March quarterly report we described our bank strategy as dictated by fairly tight price ranges and a focus on securing franked income, while satisfying the 45 day holding rule. We see banks as solid yield vehicles with limited growth. Banks continue to trade in a predictable range that is dictated by yield and sentiment.

Merger and acquisition news during the quarter included a takeover offer from Dulux for Alesco, a small conglomerate with a collection of business exposed to domestic building; the well publicised shenanigans relating to Gina Rinehart and Fairfax Media; the arm wrestle for control of Echo Entertainment, which sees James Packer being stared down by the Genting Group from of Singapore.

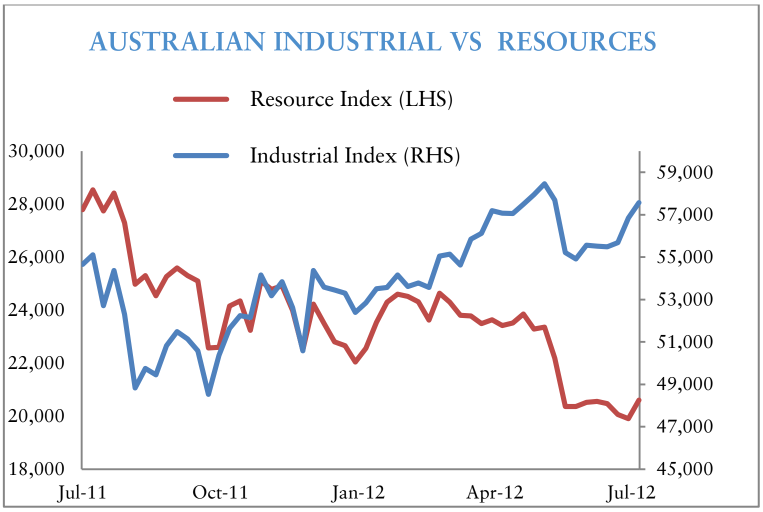
We saw a plethora of earnings downgrades as companies lowered market expectations coming into the FY12 reporting season which begins in August. The list of offenders was long, covering a broad cross-section of businesses and included: Bradken, Boral, Fairfax, JB HiFi, Perpetual, Sims Metal Management, Toll Holdings, Transfield and Wotif. The Quest portfolio does not own any of the above.

Similarly, there was a rush of equity raisings during the quarter as companies looked to strengthen balance sheets against a backdrop of weakening earnings. Some companies were dealt with harshly by the market despite new shares being priced at a chunky discount to the last traded share price. This reflected the shock associated with the raising, an attached earnings downgrade and a perception that perhaps some of the businesses were in a state of permanent decline. The list of raisings included AGL, Billabong, Brambles, Echo Entertainment and Ten. NAB also raised capital via an issue of subordinated notes.

Quest looked closely at all of these equity raisings but chose not to participate in any of the deals.

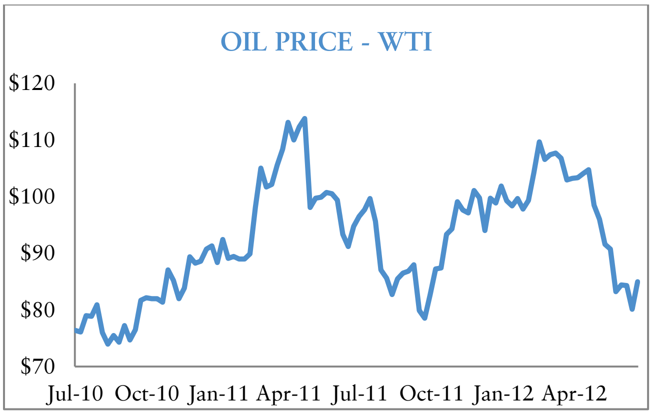
Looking at the June quarter where the Quest portfolio lagged the overall market, our worst performers were resources, particularly gold. Our three gold holdings: Doray Minerals, Alacer Gold and Newcrest Mining fell sharply despite the gold price holding around USD$1, 600 over the quarter. The best performers amongst our larger holdings included CSL which gained 10%, Telstra was up 12%, Woolworths up 3% and ERM Power rose by 5%.

The theme of industrial stocks outperforming resources can be clearly seen in the chart below. Over the 12 months to June 2012, industrials posted a small positive total return whilst resources lost around 25% in value.

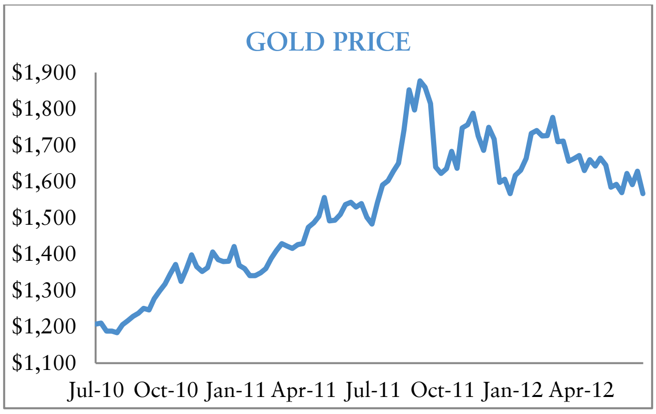


Source: Iress

One driver of this divergence has been movements in the price of oil and gold. Both have fallen significantly in recent months.



Source: Iress



Source: Iress

The Quest portfolio fared better than the benchmark over the course of the full financial year, posting a better result than the market. The biggest contributors were waste company Dolomatrix, a long-term holding which was taken over earlier in the year, CSL Limited, Sundance Resources, Transurban Group and Macarthur Coal, which also fell to a takeover during the year.

OUTLOOK

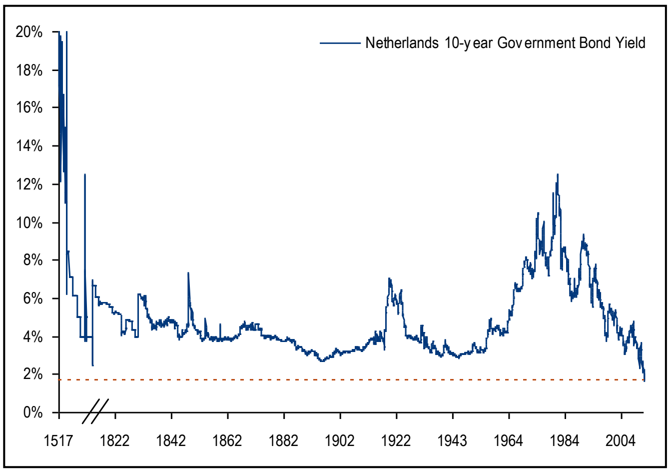
IS THE MARKET TOO PESSIMISITC?

In our view, the time to be bearish is drawing to an end.

Risk averse, defensive or seeking safety – commonly used terms used to describe the current stance of many investors in today's market. Once the domain of an extreme few, now it seems everyone is downbeat. Locally, voters are worried and want a new government, housing construction is at multi-year lows and the Australian dollar remains stubbornly high. Globally, the story is worse. The growth in US jobs is less than expected despite huge fiscal stimulus and there continues to be no resolution to the debt situation in Europe. There are plenty of reasons to be bearish but once the view becomes common or the "new norm", we think it suggests that too much negativity is being priced into markets.

This collective pessimism has been played out in asset classes around the globe. Investors have been rushing to only a handful of asset classes. Examples can be seen in G7 country government debt (excluding Italy's), physical gold and AAA rated currencies. In the longest data series we've ever seen, Dutch government bond yields are now trading at 500 year lows!

DUTCH 10 YEAR GOVERNMENT BOND YIELDS



Source: BofA Merrill Lynch Global Equity Strategy, Global Financial Data
Annual data prior to 1815, monthly thereafter,
No data: 1577-1599; 1700-1746; 1748-1761; 1763-1797; 1977-1813

Is the price of Dutch bonds telling us that the risks right now are more serious than at any time in the last 500 years of Europe's turbulent past?

Whilst this trend could continue and thereby extend the focus on defensive, yield-based investments, it is inevitable that at some stage the herd will move away from fear and start thinking about investing for higher returns. Picking this exact juncture will be difficult but we are mindful of the opportunity and are beginning to re-position the portfolio.

In Australia there are a few stocks that presently seem bullet proof. Investors want to own them and few want to sell. The list includes Commonwealth Bank, CSL, Coca Cola Amatil, Telstra, Ramsay Health Care, Woolworths, Transurban and Westfield Holdings. The common characteristics here are size, relatively defensive business fundamentals, larger dividend yields and well regarded management. Quest currently owns Telstra, Woolworths, CSL and Transurban.

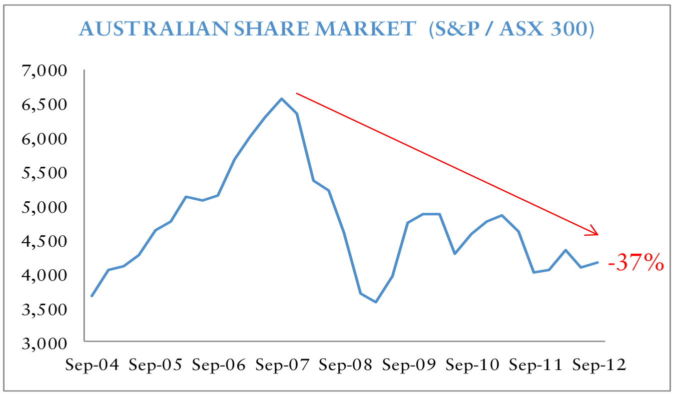
As previously discussed in past Quest quarterly reports, there have been plenty of reasons to seek out safe haven investments. What has changed is that investors are now well aware of the global problems:

- The Euro experiment has failed and is now dealing with a group of debt laden governments and banks. There are no easy remedies: trying to force the Greeks to balance their budget in a hurry, for example, has only compounded the lack of economic growth that is needed to solve the issues in Europe;
- The Chinese economy can no longer be expected to grow at 10% pa perpetually;
- Governments are being changed without creating any solutions;
- The elephant in the room: the massive US government debt ($51,941 per person) is once again attracting some attention.

The markets have had plenty of time to adapt to the new environment. An examination of previous bear markets, for example the one starting in 1969 and another from 1987, reveals that the lows were reached approximately four to five years after the peak. Even the biggest drop of all, the 1929 crash, saw the market bottom less than 3 years later.

Is a period of three to five years enough to allow markets to recover? Typically, after such a time, the evils and excesses of the previous boom are well documented, the de-leveraging is well underway and most unsustainable projects have been exposed.
Governments and regulators also begin to tackle the underlying issues. At the same time, bond yields fall and those few asset classes that have defensive characteristics are bid up to unsustainable levels creating the opportunity for riskier asset classes to perform.

Cut to today and long-term bond valuation models, including those of the US Federal Reserve itself, are saying that government bonds are expensive. Our own Quest valuation models are saying defensive stocks are at or near peak valuation levels. And the Australian market is 37% off its peak of almost 5 years ago.



Source: Iress

As Warren Buffett once said, it can be profitable to be greedy when others are fearful and fearful when others are greedy. We suspect now is the time to pay attention to such wisdom.

With the local market now historically cheap, especially in the case of less defensive sectors like mining, discretionary retail and energy, there are opportunities. We intend to focus on stocks that are trading at greater than a 15% discount to our valuations such as the recently acquired Origin Energy and Wesfarmers.

We have added to the RIO position on the same basis. Our modelling suggests that RIO is already priced for a 50% fall in the iron ore price. At this level, half of the world's iron ore producers would be operating at a loss. RIO would still be in profit as one of the world's lowest cost iron ore producers.

Quest has commenced selling our defensive investments as they attain target prices and reinvesting into quality but less sought after stocks. Given the background of European uncertainty, it will be impossible to time this move perfectly. There will certainly be more shocks and surprises but we must consider the potential for a major shift in market direction in the next twelve months.

The last time we made this call was in the September 2011 quarterly report. We were correct and the market rallied about 12% from the September trough to the May 2012 peak; a period of seven months. Similar conditions exist today.

FEES

There is no performance fee payable this quarter.