QUEST

Quest Asset Partners

QUARTERLY REPORT 2012

QUARTERLY REPORT
DECEMBER 2012

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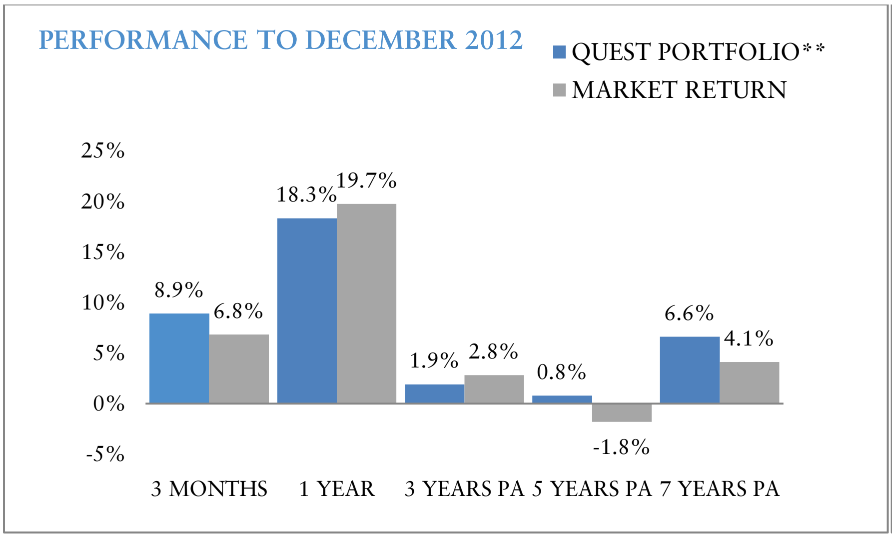
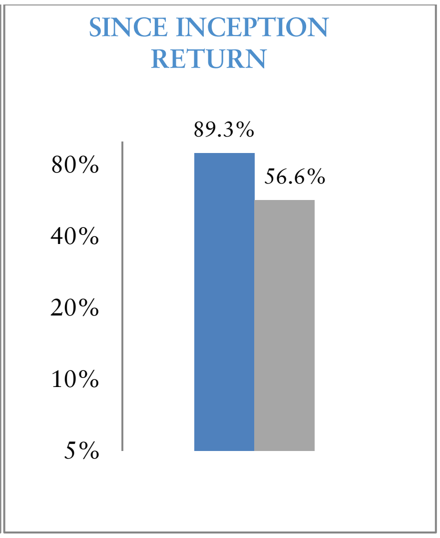
Account Name: : John Citizen	

PORTFOLIO MOVEMENT – 31-DEC-12	
PREVIOUS MARKET VALUE 30-SEP-12	
CONTRIBUTIONS DURING QUARTER	
PORTFOLIO MOVEMENT*	
MARKET VALUE 31-DEC-12	

YOUR PORTFOLIO PERFORMANCE FOR THE QUARTER*	8.90%
MARKET RETURN (S&P / ASX 300 ACCUMULATION INDEX)	6.77%

*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 SUMMARY

FOLLOWING A STRONG SEPTEMBER QUARTER, THE MARKET POWERED ON POSTING AN IMPRESSIVE RETURN OF 6.8% FOR THE DECEMBER QUARTER.

The Australian share market again performed very well in the December quarter, outperforming both the US and UK. The gains were broadly based with Healthcare (+11%), Telcos (+11%), Industrials (+8%) and Banks (+7%) leading the charge. Resources (+5%) also staged a partial comeback with some stocks posting strong returns. Energy (0%) was the notable laggard.

The ASX 300 accumulation index was up 6.8% for the quarter. The Quest portfolio outperformed, returning 8.9% after fees for the period. Quest benefited from positions in a number of strong smaller cap stocks; Comet Ridge, Codan, G8 Education and Swick Mining Services, in addition to good returns from Lend Lease, Fortescue, Henderson and Whitehaven Coal.

Turning now to the full 2012 calendar year.

Despite being one of the more difficult years for investing, the Australian benchmark returned 19.7% in 2012.

The market rose in 11 of the 12 months during 2012, a feat not achieved since 2005. This is the best return since the post GFC recovery year of 2009 where the market rose 38%. This is the fifth best result this millennium; in fact the market has risen in ten of the past 13 years, as shown in the following table.

YEAR	%
2012	19.7%
2011	-11.0%
2010	1.9%
2009	37.6%
2008	-38.9%
2007	16.2%
2006	24.5%
2005	22.5%
2004	27.9%
2003	15.0%
2002	-8.6%
2001	10.5%
2000	6.3%

Few investors picked all the trends well in 2012 but most finished with a decent return. A review of fund performance tables shows a massive gap between the winners and the losers with top funds returning above 20% while the tailenders delivered single digit returns. Hedge funds had a forgettable year with few equalling the benchmark.

Given the intensely negative economic prospects around the world in at the start of 2012, it may surprise that by year end:

- equities solidly outperformed bonds, posting the best returns in three years
- most banks did a lot better than the market
- Portuguese and Greek bonds proved to be a great investment
- iron ore would bounce back to $140 after falling to $87 from a previous high of $180 per tonne.

The defining market event this year was the shift toward earnings certainty and yield. This time last year, we in noted in our Quarterly Report that defensive stocks and quality industrials with good yields should do well in 2012. Even we were surprised by how hard investors chased stocks in the quest for yield.

The chase was taken up by overseas investors and local institutions well before local retail cash was mobilised into the equity market. Yield stocks started to climb back in February 2012 with offshore investors happy to take on the Australian dollar exposure as well. There was also a shift away from resource stocks by locals as the Chinese economy slowed. Surprisingly, we saw no tangible flight from local retail term deposits until December 2012, a full 13 months after the commencement of the local rate cut cycle 11 months after yielding stocks started to climb.

The lack of global growth, low offshore interest rates and investor aversion to risk amidst an uncertain economic backdrop saw a very wide dispersion in stock performance over the year. It was a tough period for resource stocks and a joyride for many industrials. The table below shows the stark differences between some of the winners and losers in 2012.

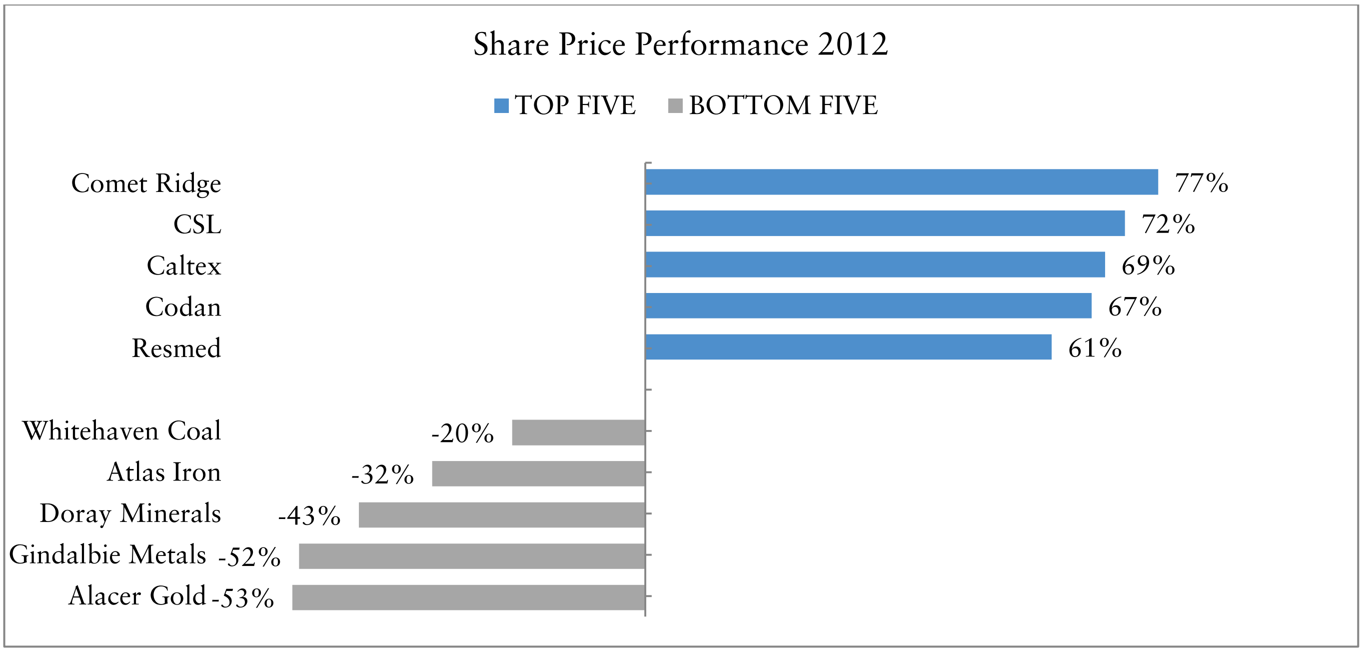
WINNERS	
CSL *	68%
Resmed*	60%
Macquarie Bank*	49%
Westfield Group*	35%
James Hardie	34%
Crown	32%
Telstra*	31%
Lend Lease*	30%
Westpac Bank*	30%
Commonwealth Bank*	26%

*Owned by Quest during the 2012

LOSERS	
Seven West Media	-46%
Lynas Group	-45%
Iluka Resources	-42%
Atlas Iron*	-34%
Oz Minerals	-33%
Fairfax Media	-29%
Whitehaven Coal*	-28%
Sims Metal	-27%
Newcrest Mining*	-25%
QBE	-16%

* Owned by Quest during the 2012

The Quest portfolios also saw some extreme performances in both directions during the year. The major price movers during the year are set out below (please note that not all stocks were held for the full year).



A couple of comments regarding the Annual General Meeting season held during the quarter are warranted.

AGM commentary echoed the mixed tone of the August reporting with some companies guiding expectations down for the upcoming first half results. Lend Lease, one of our larger holdings, pleasingly reaffirmed growth expectations for FY13 and the stock put in a good run into year end. Worley Parsons warned of a tougher first half, citing international weakness. The share price reacting badly, dropping some 15% and Quest took the opportunity to re-establish a holding in this quality company. Worley's share price has now rallied well off its December lows.

One clear conclusion from the AGMs is that corporate confidence in Australia will not return until there is a change of government. The relationship between business and government deteriorated mid-year to the point that even the government became concerned and established the Business Task Force.

Weeks later, monthly rather than quarterly payment of corporate tax for larger businesses was dropped like a bomb from Canberra leaving the business world and the Task Force gobsmacked. As Robert Milner, Chairman of Soul Pattinson and Brickworks said "this must be the most hostile government to business in the history of this country."

The first Minerals Rent Resource Tax (MRRT) quarterly return was due in October 2012. This new tax is a burdensome failure, the result of a weak understanding of the realities of the marketplace. This hastily drafted tax was poorly planned with no regard for changed economic conditions or unintended consequences.

In our September Quarterly we noted that we were unable to find a company that was expecting to pay the MRRT. We had no problem however measuring the cost of the exercise with a smaller Western Australian iron ore miner having spent $600,000 on systems, consulting, accounting and valuations in order to find no liability existed.

PORTFOLIO ACTIVITY

THE PORTFOLIO BENEFITED FROM THE PORTFOLIO CHANGES MADE DURING THE PREVIOUS QUARTER. THE VALUE OF QUEST'S PORTFOLIO NOW EXCEEDS THAT REACHED AT THE PREVIOUS MARKET HIGH. THE MARKET REMAINS 13% BELOW ITS PREVIOUS PEAK.

During the quarter a number of new positions were established in the portfolio.

Goodman Group and Westfield Group were purchased to bolster our property exposure. Our view is that the yields from quality property portfolios will continue to be sought in 2013 from both locals and international investors, particularly large pension funds. Both stocks have experienced management teams with solid reputations for development and delivery of projects. Both are internationally exposed and rate well on our Q Stock rating screen.

We also increased our position in Stockland Group. The stock continues to trade at a discount to our valuation and carries a yield of 7% at the time of purchase. We are also encouraged to see a new CEO for the company. Mark Steinert is known to us and commences early 2013. He should bring about directional change and is expected to be very focussed on driving the metrics of the business.

Hastings Diversified Utilities Fund was purchased in October during the takeover bid announced by APA Group. APA are now proceeding to compulsory acquisition having gained 98% acceptance. Hastings own and operate the Moomba to Adelaide gas pipeline, the Moomba to south east Queensland pipeline and the Karratha to Port Hedland pipeline in Western Australia. APA Group is Australia's largest owner and operator of gas pipelines and storage facilities with operations in every state except Tasmania.

The stock will gain some operational synergies from the takeover despite being forced to divest one pipeline after a ruling by the competition regulator; the ACCC. The yield to Quest was in excess of 7% at the time of purchase. Our 15% return target was easily covered by our Q Value valuation methodology. APA has already proven to be a good performer having gained around 12% since acquisition.

SAI Global has been in our portfolio twice before. After a recent price fall, we dusted off the file and visited the company for the first time since 2010. The company provides information services that manage risk, staff training and compliance solutions. The SAI share price has been weak due to recent stumbles in restructuring recently acquired businesses. We took the opportunity to buy a good quality small cap business at a good price. In our opinion, the market is not fully valuing the future benefit of SAI's restructured acquisitions, nor the growth available in its core markets.

Macquarie Group was added in October. This stock always provides our team with a challenge with complex structures, voluminous reporting detail and an eclectic collection of global operations. The stock had been falling for nearly three years but the early signs of US recovery sparked our interest. Macquarie has for some time been priced in line with leading US banks such as Goldman Sachs and Bank of America.

We expect that a turnaround in the US will lift the leading financials from the depths in 2012 to higher levels in 2013. Operationally, the stock has a stronger capital base, has consolidated back office functions and has cut costs. An increase in corporate activity globally is now required to drive further growth. With the US economy slowly recovering, the signs are encouraging. Our average entry price is around $30 and Macquarie has moved just past $35 as we write.

Finally, we bought Fortescue Metals in December. We sensed that resources were too heavily sold down and with iron prices recovering strongly, Fortescue looked good value. Fortescue is also looking at divesting a minority position in their rail and port infrastructure to outside interests, although at this stage a deal is uncertain. The other lure was China, where policy announcements from the new Central Government can be expected to assist resource demand. If both scenarios occur the stock move could be significant. Getting the right entry point is critical, as is selling at the right price. We are up 20% on this investment so far and will continue to monitor the position carefully.

During the quarter we added to our position in gold explorer Doray Minerals, which raised $55 million via a placement and rights issue to fund the mine construction north of Meekatharra in Western Australia. Site and plant construction has now commenced and first gold is expected in September 2013. We plan to visit the site in February this year.

We also participated in a placement for Orecobre, a new lithium brine producer in Argentina. Orecobre extracts lithium from water solution at substantially lower costs than extracting from ore, the method which currently supplies half the market.

Lithium ion batteries have become the primary technology platform for powering mobile devices due to a lower weight to power storage density.

The technology continues to improve and new applications are finding their way into more mass consumer devices, such as power tools, vaccum cleaners, lawn movers and devices previously not powered by batteries. This may expand to further mass market applications like motor bikes, scooters and cars in the future.

Four stocks exited the portfolio this quarter. Santos was sold after we lowered our valuation target on the stock. We have less confidence in the gas price in Australia given the fall in international prices and the continuing cost increases associated with Australian gas development. We have also taken the view that long lead time capital intensive projects are unlikely to perform in the near future. The preferred oil and gas stock continues to be Oil Search Limited.

Cost increases also led to the sale of the unsuccessful investment in Gindalbie Metals. While well advanced in developing a significant magnetite resource in Western Australia, the latest fund raising was a surprise. Spiralling costs on long lead time projects have again led to disappointment. The stubborn strength of the Australian dollar has not helped. The raising caused dilution to our valuation and we decided to cut the position. It should be mentioned that it is a significant achievement by management to develop this massive project with first production due in early 2013.

Gerard Lighting was sold into a takeover bid by CHAMP at $1.05 per share in October; this delivered a good return on a smaller stock that we wrote up in some detail in the past.

The gold price has put in a spectacular performance over the last decade but the share prices of gold companies have not performed to the same level. With hindsight, investors would have done much better in physical gold than stocks.

Our portfolio did poorly in both Alacer Gold and Newcrest. The Newcrest position was sold in September.

The problem with gold stocks is that production delays, increased costs and processing problems due to mine complexity have increased operating costs leaving profit growth lagging the gold price by a considerable margin. The larger global stocks have consistently struggled with operational issues.

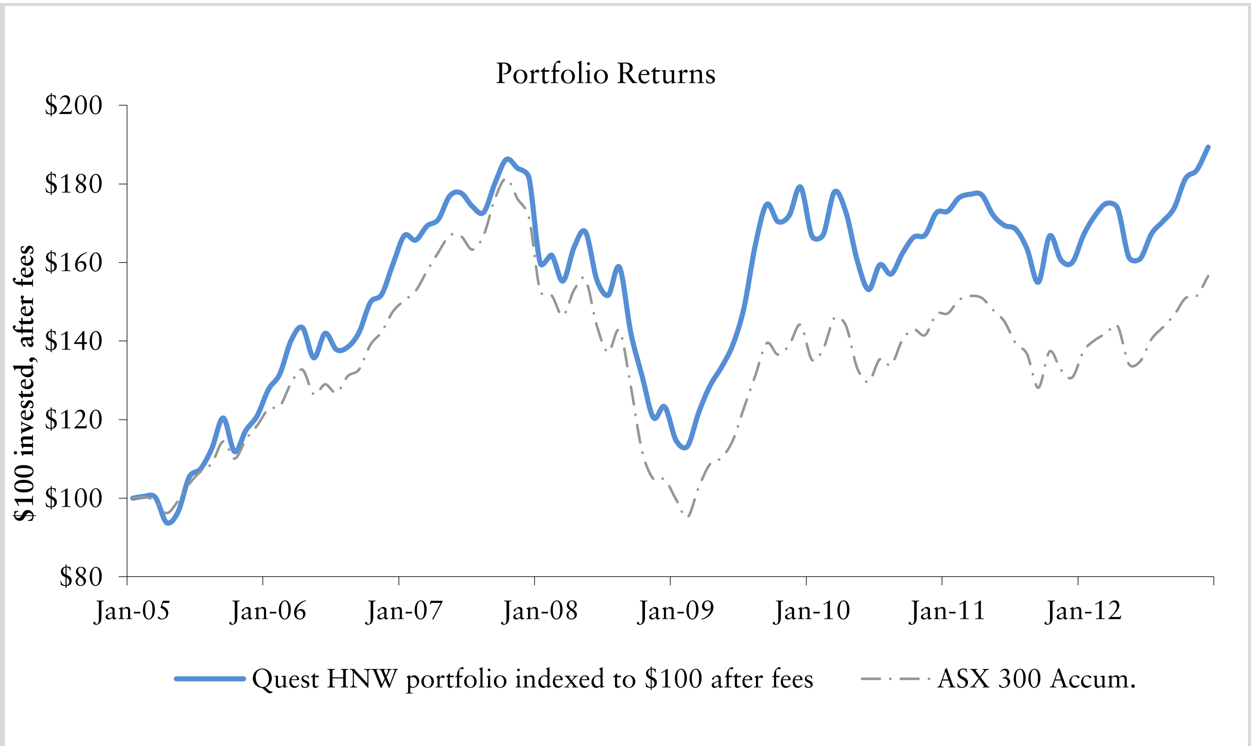
This year the largest global gold producer Barrick Gold fell 23%, Newmont also fell 23% and Goldcorp was down 17%. Newcrest lost 25% while the gold price rose another 7% over the 12 months. We have maintained our position in Alacer Gold.

During the quarter we saw very strong gains to our small stock holdings in Codan (up 67%) and Comet Ridge (up 77%).

Both stocks were reviewed in the September quarterly report however we continue to see upside in smaller industrial stocks as the market looks beyond the top 20 stocks for growth potential.

At the end of the quarter, the Quest portfolio was fully invested with cash levels sitting at 2%.

We are also pleased to report that the Quest model portfolio is now 1.7% (after fees) above the previous high established in October 2007. This is in stark contrast to the overall market which remains 13.8% off its high water mark (as at December 2012).



OUTLOOK

FALLING INTEREST RATES WILL CONTINUE TO ENHANCE THE APPEAL OF THE EQUITY MARKET. THE SEARCH FOR YIELD TO REMAIN AN IMPORTANT DRIVER. GOOD STOCK PICKING WILL BE REWARDED AS MANY COMPANIES WILL FIND IT DIFFICULT TO GENERATE MEANINGFUL EARNINGS GROWTH.

Falling local interest rates will maintain thirst for yield

With term deposit yields falling, more tax effective yields can be found in the stock market. In a world desperately short of growth we see this driver persisting into 2013, with some flurries in other parts of the market such as energy and resources.

As mentioned, the first sizeable moves away from term deposits to equities by local retail investors took place in December 2012. Since the GFC, retail money has huddled in term deposits while enjoying the safety of high interest rates. At the time of writing, Commonwealth Bank on their website are offering 4.2% for one year for amounts between $50,000 and $2 million. If your tax rate is 30%, this gives you an after tax return of 2.9%. With inflation forecast by the Reserve Bank to be between 2%-3%, most of return to the deposit holder is eaten up by inflation. Not great, but safe and a lot less than the market return in 2012.

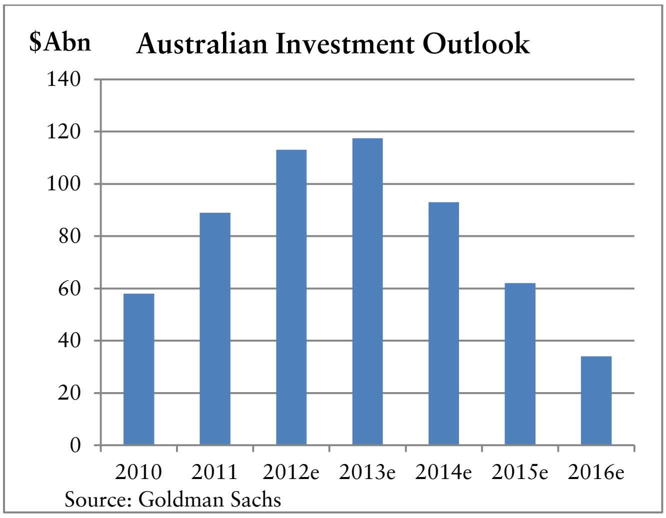
Contrast this with holding National Bank shares that are forecast to pay $1.82 in franked dividends in the coming year, half paid in July and the remainder in December. This equates to a fully franked yield of 7.3% (assuming a share price of $25.00). Assuming the same 30% tax rate, this gives you an after-tax yield of 7.3%, after factoring in the benefit of franking credits. With inflation of 2%-3%, this can be quite an attractive return compared to a bank deposit.

Capital expenditure forecasts in Australia

Australia has been the economic poster-child of the post GFC period due to the resource investment boom. This investment boom has significantly boosted employment, house construction, transport volumes, household spending and has been the major driver of +3% GDP growth.

Post GFC, demand for minerals from China prompted BHP, RIO, Fortescue and others to rapidly expand export volumes of iron ore and coal. These expansions were followed by a series of massive LNG developments involving Chevron, Conoco, British Gas, Origin, Santos, Total and INPEX. Mining investment has surged from 2% of GDP to 8%. Currently thirteen LNG trains are under construction in Australia to add to the seven already in production. This investment bonanza has been intensively focused on Port Hedland in WA and Gladstone in Queensland. Both have experienced significant cost inflation. This construction inflation, when coupled with a stubbornly high $A, now makes new investment too expensive in these sectors.

Goldman Sachs in the chart below estimate that mining investment will fall from a peak of $80bn in 2013 to only $20bn in 2016. New LNG plants are now more likely in Kenya, Louisiana or Qatar than in Australia. The RBA cutting interest rates and lowering the Australian dollar is the main offset to this capital expenditure decline.



Potential for energy export from the USA

If you are looking for some bullish morsels then spend some time looking at shale oil in the USA. Shale oil has turned into an economic free kick for the world's biggest economy. Energy prices in the US have fallen sharply while employment in the sector has risen. The US is now less dependent on the Middle East and is now a potential exporter of energy rather than the other way around. Cheap gas is driving an industrial renaissance in the US Gulf States.

The shale industry now generates in excess of 50% of gas usage in America. Five years ago the industry did not exist beyond some determined innovators that have been working on the potential source of power for two decades.

Gas prices are now less than half that in Europe and Asia which suggests export is possible. In Europe the Russian gas supplier Gazprom, who supply 25% of Europe's gas, has reported a second quarter profit fall of 50% due to weak demand. This is bad news for Russian suppliers to Europe who have enjoyed a relative monopoly over hapless Eastern European customers for years.

Gazprom have responded by planning a new LNG plant at Vladivostok with a view to selling into China.

According to the International Energy Agency in their latest World Energy Outlook, the US could surpass Russia as the largest producer of gas in the world by 2015. The Agency also suggests that the US could be a larger producer of oil than Saudi Arabia and Russia before 2020.

The 2013 outlook

Overall, our expectation is that 2013 will again be a positive year, but with lower returns than 2012, driven mostly by the significant weight of money flowing from lower returning deposits.

Stock picking will again be critical as earnings growth will be hard to find. Higher quality companies will be sought after, justifying a share price premium and dividends will continue to deliver a significant portion of total return.

REFLECTING ON THE MARKET

RUSSELL LANDER IS ONE OF AUSTRALIA'S MOST DURABLE STOCKMARKET ANALYSTS, HAVING NOW ENTERED HIS 51ST YEAR IN THAT ROLE. HE KEEPS A CLOSE EYE ON GLOBAL INVESTMENT TRENDS AND PROVIDES REGULAR TECHNICAL INPUT TO QUEST. IT IS ALWAYS INTERESTING HEARING RUSSELL'S VIEW AND A SUMMARY OF HIS OUTLOOK FOR 2013 IS PROVIDED BELOW.

One year ago the S&P/ASX 200 index stood at 4,100 striking a rather tentative note for 2012 when viewed against a peak for the previous year of 4,976. As we embark on 2013, however, there is a mood of quiet optimism both here and abroad. In early January the 200 index reached a 19 month high and most markets around the world finished 2012 well in the black for the year, notably in USA, and have had a positive start for the New Year. The only markets which finished roughly where they started in 2012 were in Canada, China, Portugal, Spain, Bahrain, and several S. American countries, notably Brazil and Argentina.

Star performers in 2012 were stockmarkets in Indonesia, Malaysia, Mexico, Pakistan, the Philippines and Turkey reached record highs. In contrast, last year was particularly disappointing for the Chinese market. Nevertheless the Shanghai A index did manage to rally by 16% over the last 21 trading days of the year, breaking a downtrend in place since April 2011 and the Japanese market appears now to be re-awakening from a three year slumber, under the influence of fiscal stimulus.

In principal driver of stock prices around the globe in 2013 is again likely to be the quest for yield, rather than the prospect of growth in corporate earnings per share.

Government bond yields are generally at historically low levels and likely to remain so, pending a marked improvement in employment levels in USA and Europe

Following the GFC, many seasoned investors fled the stockmarket for the safe haven of bank deposits and corporate fixed interest offerings. This approach must now be under serious question with the share prices moving ahead so quickly for no apparent reason. Certainly, local stockmarket volumes have been historically low over the past year but nevertheless there have been sustained rises in stocks in a number of sectors offering attractive yields, viz. banking, telecommunications, chain retailers and property trusts. This trend is continuing.

My fearless forecast for 2013 is for the local 200 index to carry 5,500, a level last seen in June 2008. Consider the following pointers:

- The 3 month moving average for the 200 index crossed its 6 month counterpart in August 2012 and remains in a bullish position, true also for other markets such as the UK and Germany. These moving averages are a simple and useful confirmatory indicator of the direction of market trends over a three to six month horizon. In a rising market the 3 month moving average will lie above the 6 month series and conversely for downtrends, crossovers denoting important turning points.

Red line is the 3 month moving average; Blue line is the 6 month moving average

- The 200 index has a chart target of 5,000 drawn from the height of the base dating from Aug. 2012 but a move above 5,000 would open a subsidiary target of 5,500 drawn from a broader base
- For this to happen, the drivers have to be banks and leading miners which account for over 40% of the index by weight. As it turns out, the bank sector has clearly broken out of a protracted base formation, led by CBA, Suncorp and Westpac. Furthermore, leading miners BHP and Rio Tinto have decisively broken downtrends in place since April 2012 and 3 & 6 month moving averages are now in a positive stance.
- It will be recalled that both the big miners were sold down to historically low price earnings multiples in mid-2012 on the premise that the resources boom was over.
- However, iron ore and base metal prices remain resilient and companies low down on the international cost curve continue to hold promise.
- Although engineering and contracting stocks catering for the resource sector still have solid order books, they were also sold down heavily in 2H12 and should recover lost ground in 2013.
- A wild card in 2013 is the building materials sector which rallied strongly in 4Q 2012 in expectation that lower interest rates would re-kindle home building. At the outset of 2013, this area of the market remains well supported.
- There are still sectors under a cloud such as departmental retailing and media, with their very raison d'etre threatened by the internet. Investors also remain cautious about energy stocks, in light of the possible medium term impact of the shale gas boom in USA on international LNG pricing.

It is possible that adverse economic data emanating from the USA, the Euro-zone and China could prick stockmarket confidence from time to time in 2013, just as was the case in 2011 and 2012. Nevertheless, the global yield famine is likely to remain the driving force, providing a solid under-pinning in the event of intermediate corrections.

The famous catchcry "cash is king" must now be seriously questioned!

FEES

Many clients are now at or above the high water mark previously established for their account. The high water mark must be exceeded before any performance fee is payable.

Clients may therefore pay a performance fee for the quarter (payable in the next quarter), depending on the timing of their initial investment and any additional cashflows.