QUEST

QUEST

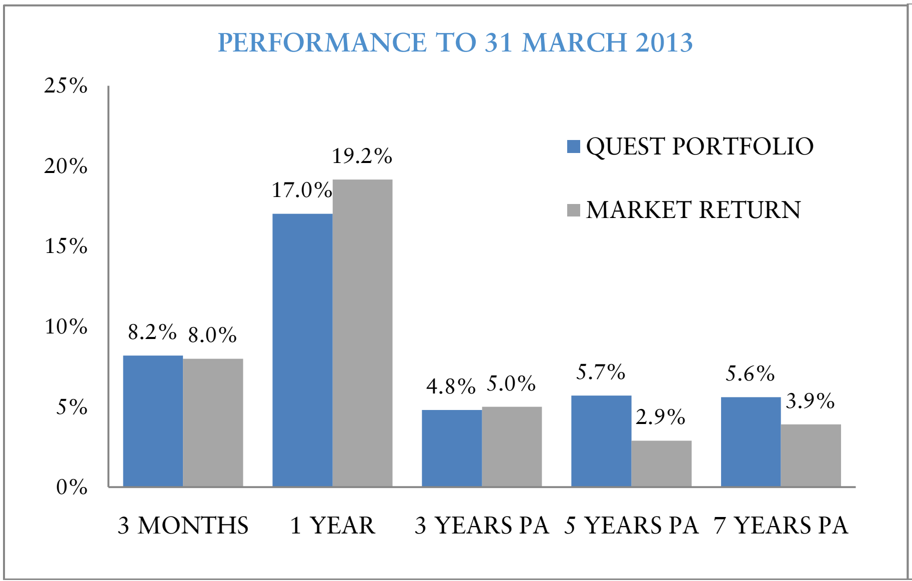
QUARTERLY REPORT

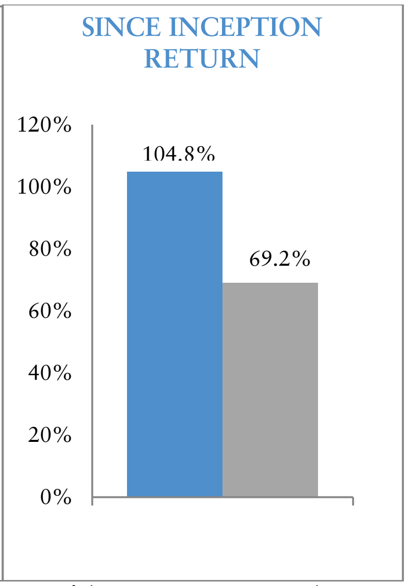
Mr John Citizen	123 ABC Street Sydney NSW 2000
Account Name: John Citizen	

PORTFOLIO MOVEMENT – 31-MAR-2013	
PREVIOUS MARKET VALUE 31-DEC-2012	
CONTRIBUTIONS DURING QUARTER	
PORTFOLIO MOVEMENT*	
MARKET VALUE	

YOUR PORTFOLIO PERFORMANCE FOR THE QUARTER*	8.16%
MARKET RETURN (S&P / ASX 300 ACCUMULATION INDEX)	8.04%

*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

ANOTHER STRONG QUARTER FOR THE MARKET. RESOURCES CONTINUE TO UNDERPERFORM AS THE APPETITE FOR WELL PLACED INDUSTRIALS CONTINUES TO GROW. A BUSY QUARTER WITH SIGNIFICANT PORTFOLIO TRADING ACTIVITY.

Investors enjoyed another fruitful quarter as the benchmark pushed up 8% over the three months. The market rose 5% in January, 5.3% in February before easing 2.2% in March.

The year started with the traditional New Year rally and a welcome absence of grim news from Europe. After five years of bear market, a significant shift from bonds to equities commenced as investors predicted an improving global economy. Cash flows into mutual funds and away from deposits pushed the US market sharply higher.

Locally, satisfactory Christmas retail sales, improved housing approvals and predictions of up to three interest rate cuts for calendar 2013 lifted sentiment. Clearance rates at housing auctions started to improve in January; even Gold Coast property showed signs of life after a well attended mortgagee auction sold more than 100 properties to a room of bargain hunters looking for a good deal.

The asset allocation shift away from fixed interest and deposits that started in December was rampant in January and February and the result was a surging market that took many by surprise. By the end of January a number of brokers were touting financial asset allocation charts that showed investors had exceptionally low historical equities exposure. By coincidence all of this occurred just before the half yearly reporting season which was better than expected for industrial stocks.

The market for yield stocks was well bid and saw good gains in banks, property stocks, Telstra and most dividend paying industrials.

The news was not so good for resource stocks and the long list of companies that provide services to the miners. Resource companies generally reported lower sales as commodity prices fell and lower margins as costs rose. The big issue is the resilience of the Australian dollar in the face of lower commodity prices, the dollar has stubbornly held well above $US parity and averaged a robust $1.04 over the quarter, well above the level expected at a time of weaker commodity prices. Resources stocks generally have declining profit profiles and little or no yield; a combination that has led to poor price performance in the quarter.

The differing performance between industrials and resources was stark. Industrial stocks in the ASX 200 rose 8.8% while the resources sector fell 9.3%. A total of 35 industrial stocks in the ASX 200 rose by 20% or more over the quarter while 17 resource stocks fell by 20% or more. BHP and RIO fell by 10% and 12% respectively while National Bank rose 23%.

The major additions to our portfolio during the quarter were the purchase of Woodside Petroleum, News Corporation and BlueScope. We also purchased unlisted shares in iSelect which is expected to commence an IPO marketing campaign in April.

An internet based company, iSelect provides a price comparison service for health insurance, car insurance, life insurance, electricity and gas supply. The company provides free web site access to comparative pricing from a range of suppliers. iSelect makes money by converting an inquiry into a sale of an approved product. A fee is charged to the product provider. iSelect health insurance providers include HCF and NIB. We anticipate iSelect will list before June 2013.

Woodside reappears in our portfolio after a lengthy five year break. The price is 30% lower than in 2008 despite the company profile being significantly de-risked. The development of the Pluto LNG Project in Western Australia is now complete, after delays and cost over runs. It now generates significant cash and there is a good chance the next big project, Browse LNG, will be deferred. This leaves the way open for the new management team to consider a buy back, higher dividends or address Shell's 23% ownership of the company which is perceived to be affecting the share price. Shell has previously reduced their holding. Woodside is now less likely to move into a major new project without a partner to reduce risk post the cost issues at Pluto. Debt is falling and cash flow is strong. Woodside has a large franking balance and is well positioned to boost dividends.

BlueScope Steel has been under massive pressure in recent years with escalating input prices, high debt, a higher $A and lower demand pressuring the business. The company has made significant changes to operations and is well positioned to benefit from any upturn in the Australian or US construction markets. We expect new iron ore supply from BHP, RIO and Fortescue to affect iron ore pricing. A slower rate of growth in China in 2014 will also make the price of iron ore feedstock lower, in our view. The new joint venture with Nippon Steel in Asia has cleared all remaining debt and is expected to lift growth potential in a number of Asian markets.

Quest also added News Corporation during the quarter.

The company intends to split the large digital satellite, TV and film businesses from the smaller print operations in June 2013. We expect this will close the discount applied to News valuation relative to other US media companies. Chief Operating Officer Chase Carey has emphasised his focus on business improvement rather than growth led by acquisition. A detachment from the Murdoch style is apparent. News continues to utilise strong cash flow to buy back News stock on market. We are also keen to increase the US dollar exposure to the portfolio in anticipation of a weaker Australian dollar later in the year.

During the quarter we sold our holdings in Fletcher Building, Boral, Worley Parsons, Orica and Transurban. All had met targets and were sold after good gains. While Orica and Transurban have been long term holdings, our target prices were achieved quickly in the case of Fletcher Building, Worley and Boral. In fact Worley, purchased at less than $24, was only held for a matter of weeks until a sudden price movement up to $27 saw our target price attained much quicker than expected.

Alacer Gold and Newcrest were sold at a loss after dismal performances by most gold stocks globally. The gold price continues to track sideways however the steadily rising trajectory of the last decade has ceased. Investors are more interested in the flexibility of gold Exchange Traded Funds (ETF's) which carry gold price exposure without the specific risks of producing companies. These ETF's have seen spectacular growth over the last five years. It is possible that this growth has peaked and an unwinding of this growth could further subdue stock prices. Operational issues for gold producers continue with cost rising as mines become technically more challenging. In the US, increased turnover amongst managers of major gold companies suggests that Boards are paying the price for acquisitions and expansions that have not delivered. The lack of standard cost reporting in the industry is another hurdle that the industry needs to correct. We may revisit these stocks later in the year.

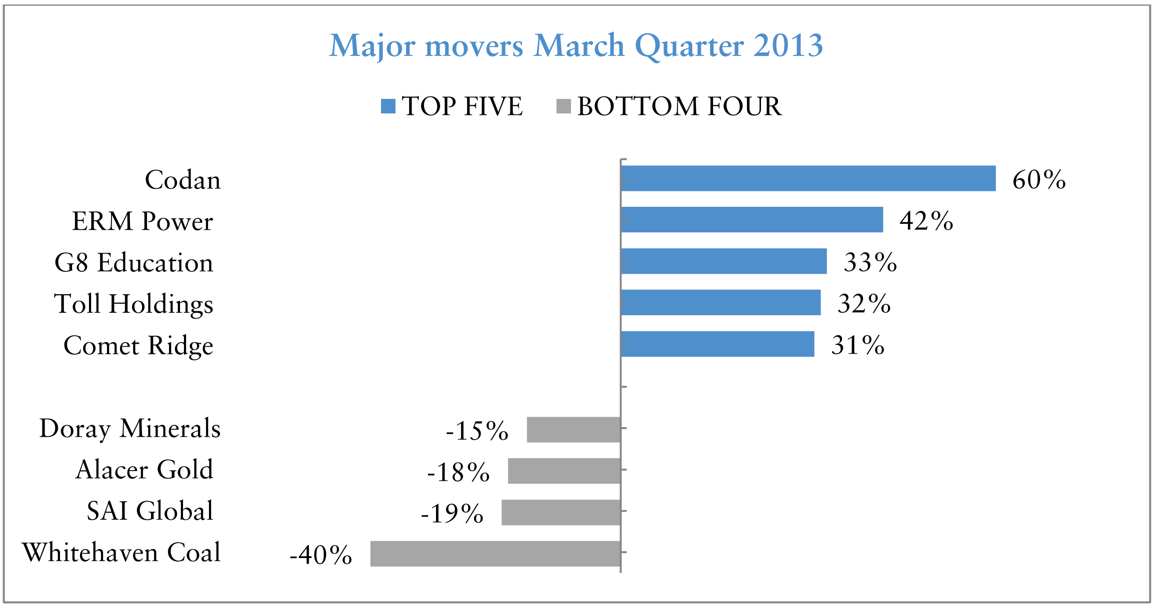
We retain our holding in gold explorer Doray Minerals which will commence production from the Andy Well deposit north of Meekatharra in Western Australia in the September quarter. We visited the construction site for the second time during the quarter. The key to this investment is expansion of the existing resource. In February the company announced increased resource at a nearby location and we anticipate further discoveries as well as initial revenues before year end.

A number of positions were reduced in February and March as the market reached new highs. These included Macquarie Bank, Australian Stock Exchange, Computershare and ERM Power.

During 2012 a number of small caps were added to the portfolio and they delivered in this quarter. Codan rose 59%, ERM Power rose 41%, G8 Education up 33%, Toll Holdings 32% and Comet Ridge 30%. Our bigger stocks also went well; National Bank lifted 23%, Australian Stock Exchange 18% and Westpac 17%. Our resource holdings were disappointing with Whitehaven Coal, SAI Global, Alacer Gold and Doray Minerals all down as seen below:

Corporate deal flow is an important measure of market health. This quarter activity improved from a low base with deals being enthusiastically absorbed by willing buyers, particularly for smaller stocks.

In January, 20% of iron ore miner BC Iron was sold by an Asian investor to enthusiastic locals. In March, News Limited sold their holding in SKY TV New Zealand to equally keen local buyers. Clough limited sold a 35% holding in Forge Group for a handy profit and banked $187 million. The Queensland Government again sold down their holding in Queensland Rail (now known as Aurizon Holdings) from 18% to 9% in March. Industrial waste business Transpacific Industries saw a large private shareholder sell an 11% holding. Amongst the gold stocks, Papillon Resources and Beadell Resources displayed some astute market timing by raising money just before the gold price fell from $1600 toward $1550 per ounce. Gold producer Troy Resources bid for Azimuth Resources in an agreed deal. We expect more consolidation amongst would be producers this year particularly in Africa and South America.



Quest only participated in one of these deals: the BC Iron sell down at $3.55 per share in January where we had a $4 target. The stock was sold at $3.96 in February.

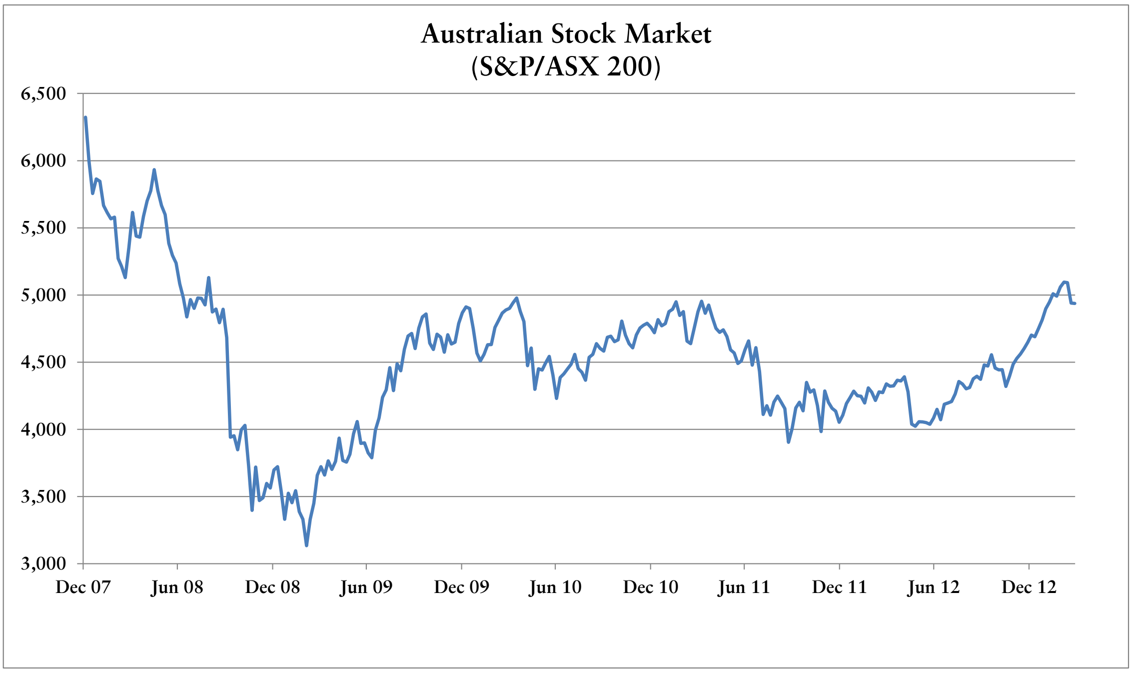
In January, Michael Chan visited China, experiencing first hand the extent of their pollution problems. Overall his conclusions were that the new Chinese Central Government was unlikely to deliver any major stimulus by mid year. Rather we expect a more constrained approach with an emphasis on controlling asset prices and containing inflation. The important role of shadow banking in China was also a focus with the lack of controls in this area attracting the attention of the Central Government. Most importantly, we now see little prospect for ongoing high commodity prices for the balance of the year driven by the growth of China.

Our team have also conducted numerous company visits in Sydney, Melbourne and Perth during the quarter. We have noticed an increased acceptance amongst corporate management that business needs to adapt to the high Australian dollar. Waiting for the currency to recede is no longer a credible business strategy. The first course of action has been a reduction in labour costs and a search for greater efficiency. The shift occurring from expansionary activity to a focus on efficiency is being led by the larger companies and is dictating a greater need for discipline amongst the smaller companies.

OUTLOOK

COST SAVINGS AND EARNINGS GROWTH NOW BEING DELIVERED BY DOMESTIC INDUSTRIAL COMPANIES. STOCK PRICES HAVE REACTED POSITIVELY. WITH RECORD LOW INTEREST RATES, THE MARKET MAY CONTINUE TO RUN.

The market has risen in 13 of the last 15 months. As interest in equities tends to increase as markets rise, rather than the other way around, it is timely to step back and look at the terrain as we see it now. The chart below shows the path of the Australian stock market over the past 5 years.



Source: IRESS

The lows of the GFC are now four years behind us and since an initial recovery in the second half of 2009 the Australian market had failed to advance. Fears about Europe surfaced in 2011 and persisted for more than 12 months.

In our June quarterly last year we wrote an article entitled "Is the market too pessimistic?" At that time we noted that much of the bad new was well understood and already built into stock prices. The Australian market was then around 40% below the peak of 2007.

Our European trip in September 2012 revealed that genuine attempts were being made to address the serious imbalances confronting many economies and market players were positioned for more bad news, either sitting on the investment sidelines holding cash or actually being "short" the market. Not surprisingly, world share markets began to rally hard, preferring to look across the valley to future earnings.

This was well supported by ongoing money printing (now called quantitative easing) in the major developed markets and record low bond yields.

At the end of March, the Australian market was up 21% from 30 June 2012. The strong run up in share prices is outpacing the growth in earnings currently being delivered. The result is the market effectively paying up in advance for future growth as stocks trade on higher Price to Earnings (P/E) ratios.

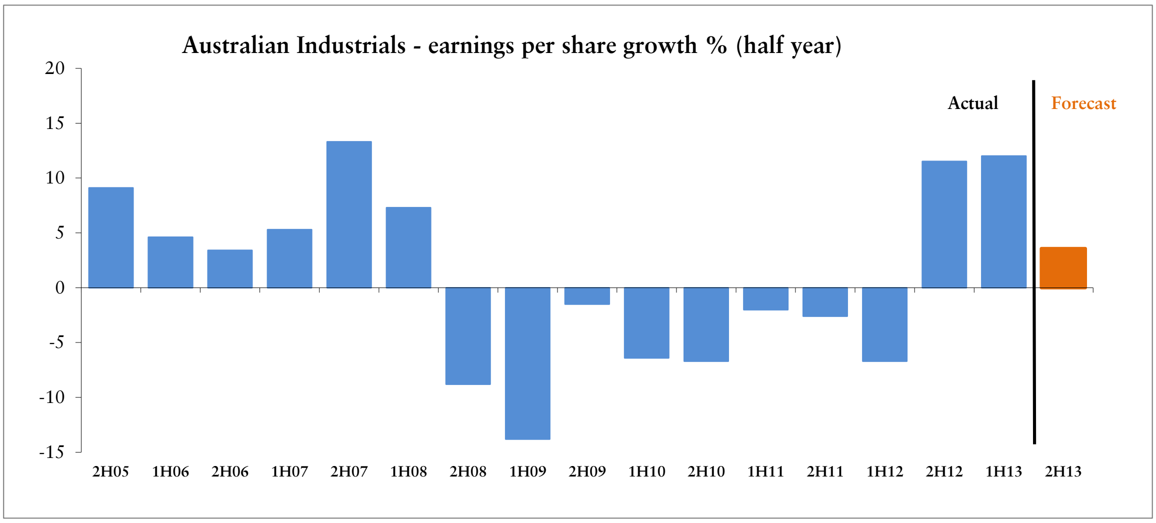
Can we justify this stellar run based on economic fundamentals? The answer appears to be a qualified yes.

Looking back at the earnings growth generated by listed Australian Industrials companies since the GFC tells a tale of chronic disappointment. The chart below shows that earnings have consistently gone backwards since late 2008. An analysis of broker earnings forecasts through this period would see that growth estimates typically started high (with the market optimistic that growth was returning) but ended negative as the reality of each year unfolded. It was this state of persistent earnings contraction that weighed heavily on the market.

The chart also shows that Industrials have now posted two consecutive halves of better than average earnings growth. Against the backdrop of the last four years, this is significant. With markets looking 12 months ahead and the trough in earnings now behind us, it is not surprising share prices picked up in the back half of 2012. Looking at this measure alone, the recent strong performance of the market can be justified.

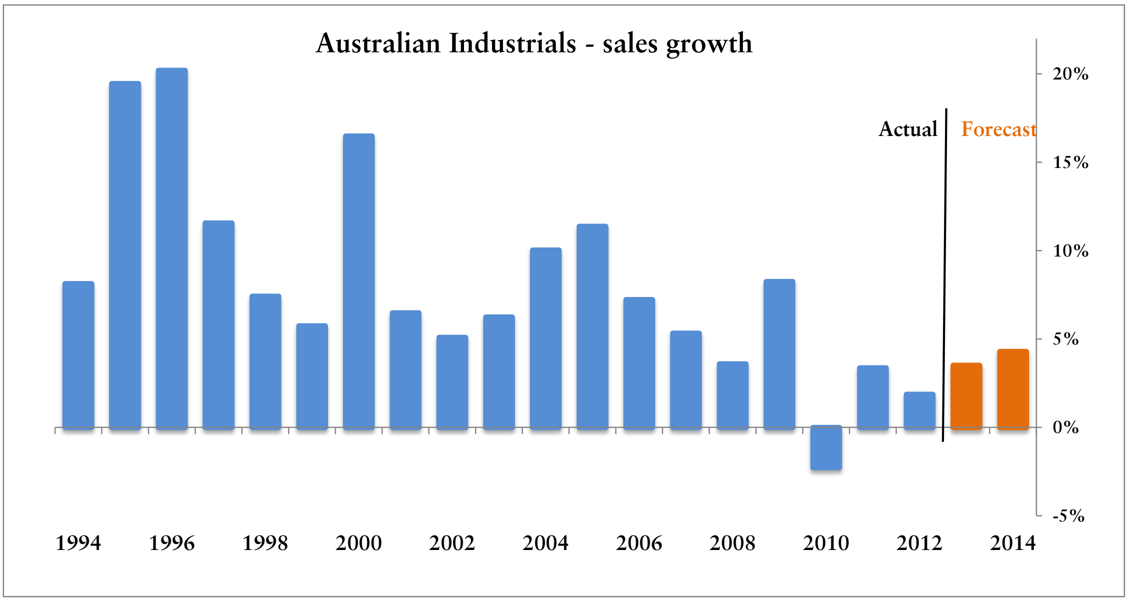
Note that analysts are only prepared to forecast modest growth from this point – the orange bar in the chart above. Should this prove to be conservative we will see further earnings upgrades; typically positive for share prices.

Decomposing the last round of corporate earnings reported in February, companies are now heavily focused on cutting costs. Media stories on redundancies and restructuring are now commonplace: all four of the major banks, Boral, BlueScope, Qantas, CSR, Toll, GWA, Fairfax as well as BHP and RIO are cases in point. This phase has further to run and will leave companies leaner and more leveraged to margin expansion if revenues grow.



Source: Macquarie Bank

Revenue growth has been all but absent in recent years with industrials the victim of the high Australian dollar and the two speed economy. This is evident in the chart below. The orange bars show the current forecasts for revenue growth in the next two years.



Source: Macquarie Bank

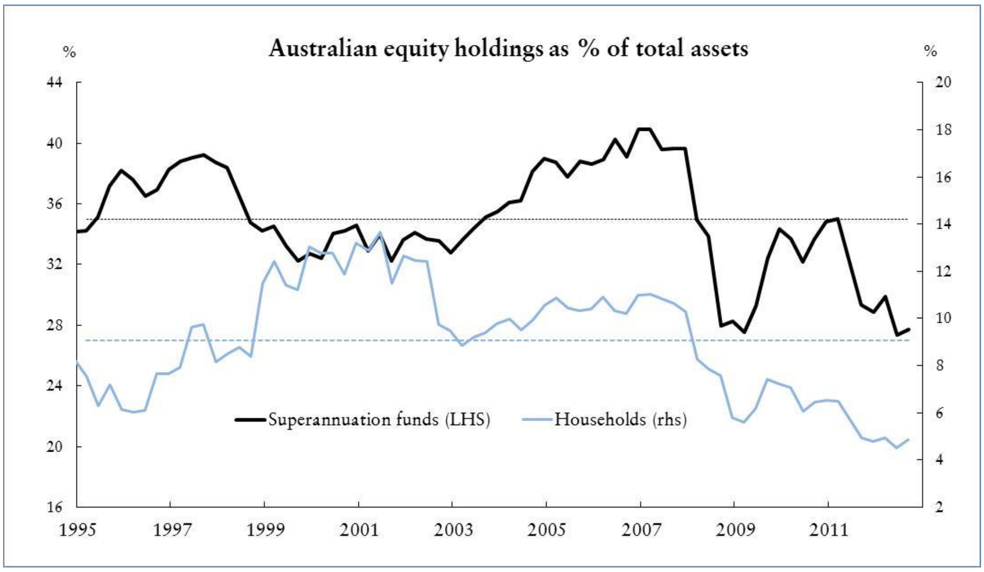
A strong rebound in revenue is not imminent, however positive signs are emerging. Notably, domestic discretionary retailers have been doing better in recent months. Interest rate cuts totalling 1.25% since mid 2012 are now showing up at the revenue line. Myer is a good example: same stores sales growth has been consistently negative until recent results for the December 2012 half. A positive figure was reported and led to an instant price response.

We believe the Reserve Bank will leave interest rates on hold for now. Should the domestic economy worsen, the RBA have the option to cut rates again until they get the desired response. The RBA has cut rates prior to a Federal election once before!

We have in past quarterlies highlighted the huge amount of cash sitting on the sidelines in term deposits and other fixed income accounts. This has been a phenomenon across the globe, being one symptom of the years of volatility and uncertainty associated with the global credit crisis. The chart below highlights the disparity in investment flows for US retail investors since 2006; bonds have seen great inflows and equities the reverse.

On this chart, equities appear to have only just started retracing the trend of the last seven years.

The recent market run has been partly fuelled by cash chasing a more lucrative return in the share market. Global funds started this process a year ago while in the domestic market the process is still at an early stage. In our opinion there was no cash transition to equities until December 2012. The chart below shows the holding of Australian superannuation funds and domestic households in equities. Both remain well below the average of the last 15-20 years.



Source: ABS, Deutsche Bank

This is consistent with our own anecdotes collected as we interact with clients, banks, and advisers; that despite seeing some movement there is still a lot of cash to be mobilised. Investment advisers in particular report a high level of enquiry. Should world markets remain stable, we expect an ongoing migration of domestic money returning to the share market. As governments as in the US, UK and Japan print money in an attempt to lower rates and lower their own currencies, money will move toward higher yielding investments. The Australian market is very well placed in this scenario particularly in the industrial stocks. This has the potential to continue for some time.

FEES

As most clients' high water marks have been exceeded, a performance fee for the December quarter 2012 has been deducted from the portfolio in this quarter. This will depend on timing of initial investment and any additional cashflows.