Quest Asset Partners

quarterly report – June 2013

QUARTERLY REPORT

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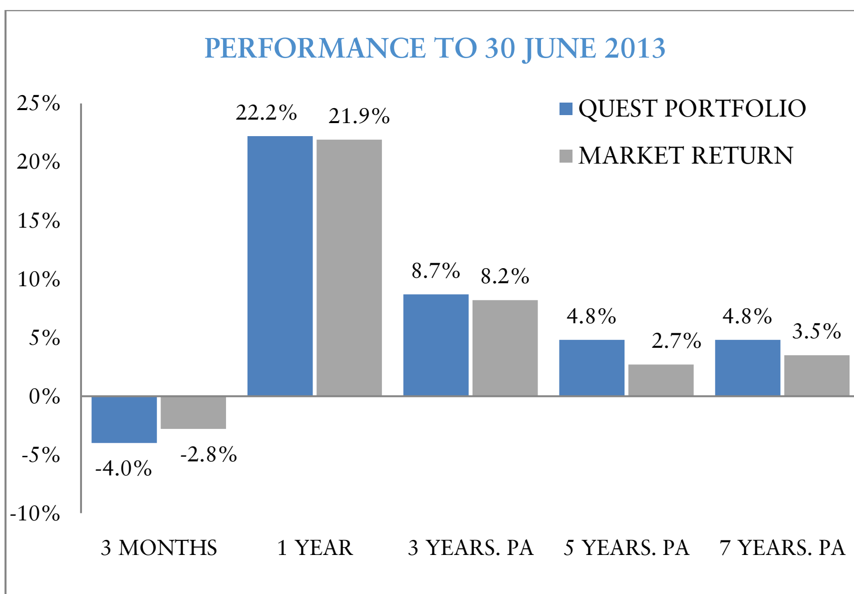
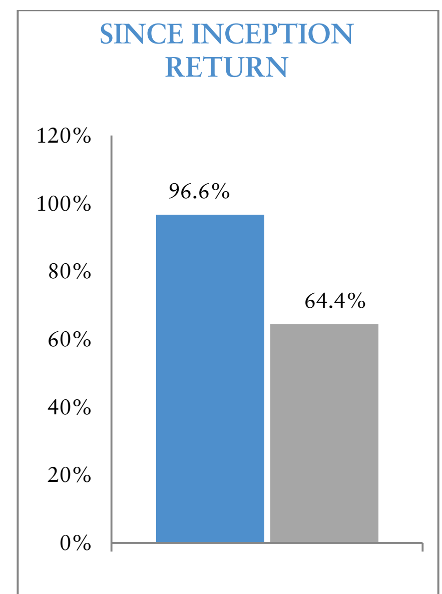
PORTFOLIO MOVEMENT 30-JUNE-13	
PREVIOUS MARKET VALUE 31-MARCH-13	
CONTRIBUTIONS DURING QUARTER	
PORTFOLIO MOVEMENT*	
MARKET VALUE	

YOUR PORTFOLIO PERFORMANCE FOR THE QUARTER*	-4.00%
MARKET RETURN (S&P / ASX 300 ACCUMULATION INDEX)	-2.83%

*Includes fees for the quarter





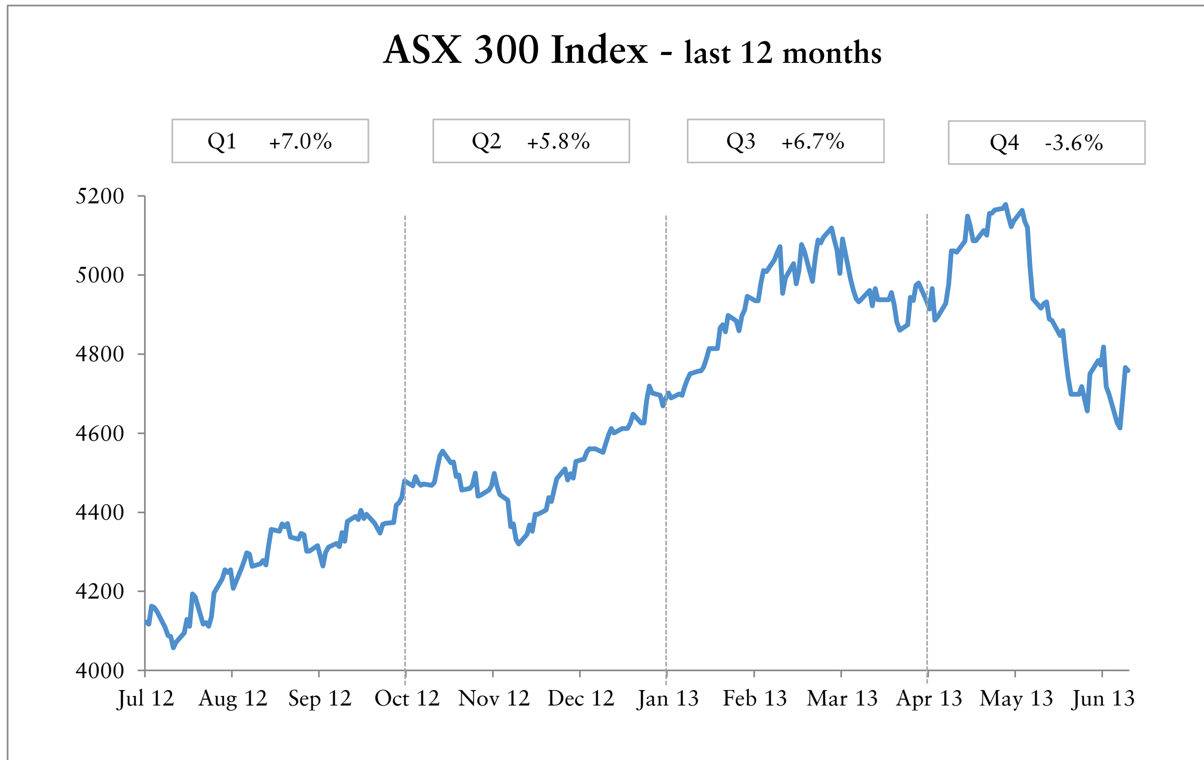
The portfolio returns quoted above represent the return achieved if invested in the Quest portfolio since inception (February 2005). Individual returns will differ for investors that made an initial investment after this inception date or where additional investments or redemptions have been made. Quest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

MARKET SUMMARY

AFTER STRONG RETURNS FOR THREE CONSECUTIVE QUARTERS, THE AUSTRALIAN MARKET RETREATED IN THE JUNE QUARTER. US BOND YIELDS AND CHINESE GROWTH DOMINATED DISCUSSION. THE QUEST PORTFOLIO REMAINS POSITIONED TO BENEFIT FROM CONTINUED WEAKNESS IN THE AUSTRALIAN DOLLAR.

The Australian market was down 3.6% in the June quarter, the first negative quarterly return since June 2012. Including contributions from dividends, the quarterly return for the market was -2.8%.

It was been an impressive 12 month run for the Australian market, hitting a five year high in May before falling back to post a 21.9% total return for the 2013 financial year. The chart below shows the path of the ASX 300 Index along with the return for each quarter during the year. Please note that returns here do not include dividends received during the period.

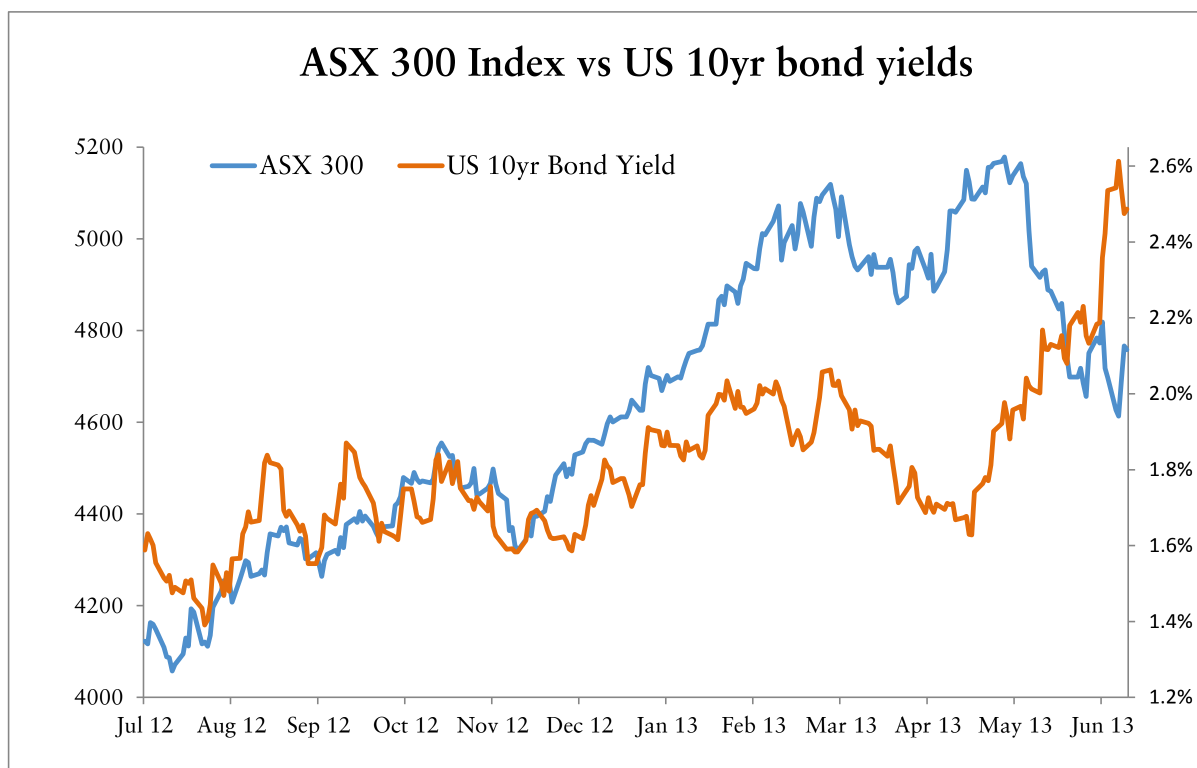


Source: Iress

Three issues contributed to the reversal in markets during the June quarter.

Firstly, the suggestion by the US Federal Reserve that the strategy of printing money and buying bonds, known as "quantitative easing", may be slowed later this year was not welcomed by global markets. This "tapering" of monetary support led to a sharp reappraisal of pricing in most asset classes and can be most clearly seen in the spike in US 10 year bond yields.

The chart below reproduces the ASX 300 index from the previous page with the addition of the US bond yield (in orange) on the right axis. The impact of the Fed's comments in May is clear: bond yields rose sharply and the Australian equity market fell. Since this time we have also seen a stronger US dollar relative to the Australian dollar, lower gold prices and higher interest rates in many of the world's markets.



Source: Iress

Secondly, the outlook for China suggests that the economy is facing ongoing challenges as the government seeks to dampen the housing bubble and control the unregulated system of shadow banking that makes portions of the Chinese banking system so mysterious. We have highlighted the lack of transparency and controls in the Chinese financial system in our past quarterly reports and are not surprised that the government are now acting to improve the system. While the markets are hoping for some stimulatory response from the Central Government, we think it is less likely to happen. The longer term strategies of the Central Government are centred on domestic housing affordability and have little concern for the short term aspirations of Wall Street.

The prices of commodities most relevant to Australia continue to struggle. Coal and iron ore are our major exports in dollar terms. In June 2012 the price for metallurgical coal was US$221 per tonne and is now US$130. Thermal coal has fallen from US$89 to US$79 per tonne. Iron ore at June 2012 was US$134 a tonne, peaking at $158 in February and is now US$120. Fortunately the Aussie currency has fallen from US $1.02 to US $0.93, which acts to cushion the impact on mining earnings as sales are translated back to Australian dollars.

Thirdly, an intense period of austerity has been launched by mining companies which is directly affecting the many service providers that service the mining industry. This whole sector has provided strong growth now for over a decade. With mines being closed, development plans put on hold and staff sacked, the impacts are significant. As previously discussed, the launch of a poorly planned mining tax right at the cyclical high was a mistake and reflects a flawed understanding by our politicians of the realities of business in Australia.

With this less favourable local back drop we continue to shift the portfolio in favour of companies that earn US dollars and those with sustainable yields.

We began this process sometime ago given our expectation that the Australian dollar would weaken. It is hard to find a reason for the Australian dollar to stage a sustained comeback and we expect further weakness in the months ahead. This portfolio shift comes at the expense of smaller companies and mining stocks.

Specifically, we have added BlueScope Steel, News Corporation, QBE and Resmed all of which generate US dollar denominated income. The addition of insurer Suncorp Group and Woodside Petroleum also augments portfolio yield.

Price targets were achieved in Australian Stock Exchange, ERM Power, G8 Education, APA and Toll holdings. We exited all these positions in the quarter.

Our mining exposure was reduced substantially with Alacer Gold, Atlas Iron and Whitehaven Coal being sold during the quarter. A position in BHP, previously absent despite the company's size, was added to the portfolio.

BHP is now trading below our valuation and is, in our view, the highest quality resource company in Australia.

We also exited the last of our holding in Codan. This has been a terrific performer for the Quest portfolio with an average entry price of around $1.40 and good profits booked from sales at prices above $3.00. Disappointingly, the company surprised the market in June with a earnings downgrade and we sold our residual holding at lower prices, though still at a profit.

A number of positions were trimmed in stocks that performed well during the quarter and achieved or went close to our target prices. These included Henderson Group, Macquarie Bank, Stockland, Telstra and Westpac.

During the quarter we continued to focus on fully franked income, particularly from financial stocks. As a result, we are carrying more in banks than usual - in fact we own all four majors at the moment as well as Macquarie Bank and Suncorp. In May, three banks went ex-dividend - ANZ, Westpac and National Bank. We like owning banks at this time as the lure of dividends provides both share price support and good tax effective income for our investors. After the ex-date passed, we bought CBA on a sudden market dip at the end of May. We anticipate that we will rationalise our bank holdings in the future.

Quest committed to a new float in the quarter. iSelect, in which we have held unlisted shares since January 2013, is an internet comparison consumer site that deals predominantly in health, electricity, gas and car insurance. iSelect floated in June and we took up additional shares in the float on day one. We are obviously disappointed with the poor debut of the stock (trading $1.65) being below the $1.85 issue price however we have not changed our positive view on this stock. As 2013 tax returns are completed, many will discover their health insurance costs may have increased by up to 40% due to the removal of the private health insurance tax rebate. We expect a fair proportion of those affected will reassess their level of insurance cover over the next 6-12 months. Given it originates around 20% of total health insurance sales in Australia, iSelect should see increased activity as a result.

Overall, the Quest portfolio performed roughly in line with the market (before fees) for the June quarter. The biggest positive contributors to the Quest portfolio were News Corp (which demerged during the quarter into two new entities: 21st Century Fox and News Corporation), Telstra, Macquarie Bank, Henderson Group, ANZ, CBA and CSL. These were offset by falls in Doray Minerals, Fortescue, Codan, Atlas Iron, Lend Lease and Comet Ridge.

Due to the strength of the market, capital gains were realised during the year. With recent portfolio changes some of our poorer performing holdings were sold and the losses used to reduce the tax liability passed on to our investors for the financial year.

A PERSPECTIVE ON THE UNITED STATES

MICHAEL EVANS VISITED THE UNITED STATES TO GAUGE THE STRENGTH OF THE US ECONOMY. THE HOUSING RECOVERY IS WELL UNDERWAY. ELSEWHERE CONDITIONS REMAIN PATCHY BUT HOPES REMAIN FOR A BROADER PICK-UP IN ACTIVITY.

Late in May, Michael Evans travelled with three other fund managers together with Deutsche Bank analysts to the United States to gauge the strength of the US economic recovery. Meetings were conducted with a total of 24 companies, listed below.

The timing of the trip was deliberate and fortunate. A period of strong performance in the US equity market has reflected the ongoing recovery in the US economy with falling jobless claims, rising house prices and increasingly buoyant housing approvals. We were keen to assess whether the momentum might be slowing given the more recent headwinds of higher employee payroll taxes on worker's take home pay and significantly reduced US government spending (the 'sequestration').

Overall, confidence in the economy and the prospects for further job growth was stronger than during our last visit to the US. Not all sectors are firing and conditions remain patchy but the outlook is positive and encouraging.

The first stop was Texas. A meeting with a house builder reflected the buoyant tone of this sector of the US economy: conditions are strong. In many US localities house prices are rising. Even the most depressed housing markets like Arizona, Nevada and Florida are seeing recovery. House builders are now struggling to keep up with demand. Prices are being increased; however demand remains unsatisfied in many cases. Interest rates on mortgage are still incredibly low despite recent rises (associated with higher US bond yields) which has pushed thirty year fixed rate mortgages back above 4%.

Despite home building activity being only a small portion of US GDP, rising house prices are fuelling hopes that the US recovery will continue. Higher home prices have a large positive multiplier impact on American families, especially when coupled with improved job certainty. It is hoped that this will have a knock on effect of increasing consumer spending which contributes a significantly larger portion of total GDP in the US.

Worley Parsons also have their US operations based in Texas. They employ 6,000 people in the US assisting major oil and gas customers to design, build and maintain energy facilities. Local operations are still a modest part of total revenues but are growing. The availability of huge volumes of relatively cheap gas is driving new chemical and LNG investments in the US. It is estimated that some $28bn will be spent on the Eagle Ford shale gas fields in Texas in 2013 by a number of companies including BHP Petroleum. Worley are keen to increase its involvement in this division. The stock at $21 is significantly lower than we sold in February 2013 at around $27.

Outside of the house builders and industries associated with shale gas, the messages were more subdued. Confidence is widespread but the tone more tempered. For example, in Chicago Illinois Tool Works (ITW) used the word 'tepid' to describe what they were seeing.

ITW are a terrific US bellwether with a vast spread of industrial supply businesses. Internally they use sales of their own steel strapping sales as a lead indicator of general US economic activity and it was from this that indicated that conditions remain lukewarm.

Similarly, the US retailers visited spoke of small revenue gains in the region of 2-4% for 2013. They were confident the recovery was underway but had low expectations for the actual rate of growth. This was a message reported in most companies we saw.

Also of note was the significance of "omni-channel" retailing in the US. Physical retailing is changing but hasn't died yet. Big US retailers have made large investments in providing competitive on-line sales venues to operate alongside their physical assets.

An omni-channel offering is now regarded as a competitive strength over those retailers with only a virtual footprint. The most successful in this space have been directing all of their marginal investment dollar towards online rather than bricks and mortar improvements. As an indication, not one US retailer visited is planning to increase store numbers.

As expected, US retailers are well ahead of their Australian counterparts in terms of on-line capabilities. They have better developed delivery capabilities, including in-store delivery of on-line purchases and delivery from store inventory. Customers can now even scan an item's bar code in store on their phone, then find and order the correct size from another of the company's stores. Innovation is an extremely common word in US corporate vernacular.

Another standout feature of the US landscape was the widespread use of company buybacks. Almost every company visited had an active buyback. US corporate gearing is low and debt is currently cheap, so buybacks are very accretive. Corporates remain uncertain about making large investment

Previously the US economy had been described as 'the leper with the most fingers'. That is no longer the case. The US economy is recovering and that centre of innovation and capitalism is re-emerging. As stated above, Quest has been progressively increasing our exposure to $US earnings with investments in News Corp, CSL, Computershare, Resmed, Bluescope, Macquarie and QBE.

Companies visited

Meritage Homes	Luxottica	News Corp
Worley Parsons	Procter &	UPS
James Hardie	Fifth Third	Peco Pallets
Sims Metal	American	Boral
Arcelor Mittal	Deutsche Bank	Coca-Cola
Kraft	Macquarie	Visy USA
Illinois Tool	Bank of	Brambles USA
Macy's	Footlocker	Home Depo

OUTLOOK

THE MARKET IS CURRENTLY OBSESSING OVER THE SLOWING OF STIMULUS FROM THE US FED. WE EXPECT THE FED NOT TO DISRUPT THE RECOVERY NOW UNDERWAY. THE MARKET LOOKS REASONABLE VALUE, HAVING FALLEN FROM THE HIGHS IN MAY, PARTICULARLY IF INTEREST RATES ARE CUT FURTHER.

The potential impact of tapering of quantitative easing ("QE") by the US Federal Reserve is the current obsession of world stock markets. However, it is not often raised by those on the ground managing the operations of companies in the US. In that sense, tapering remains the elephant in the room.

The US Fed is currently spending $85bn per month to keep interest rates low in order to stimulate economic activity. It appears to be working with house prices rising and family balance sheets improving. With outgoing chairman Ben Bernanke signalling a possible reduction in these asset purchases, the concern is that mortgage rates may rise to levels that will constrain US households which could threaten the recovery underway. Higher interest rates will also increase the cost to the US government of servicing their enormous debt.

There are few historical examples in the world where monetary stimulus of the size and nature pursued by the US Fed under the current QE programme has been withdrawn. The markets remain agitated as they consider how this might play out. The Fed is clearly aware of the impact of their actions on global markets, with the recent rout in US Treasuries a clear example. The risks from pulling on the QE lever too hard are clear and substantial. For this reason, we expect the Fed to keep stimulus in place until they are certain the economy can stand on its own two feet. With Ben Bernanke retiring, responsibility for completing the exit from the QE will shift to others, some of which appear to favour slowing the process rather than speeding it up. Markets will respond favourably to any perceived moderation in the withdrawal of monetary stimulus.

Turning back to the real world of economic activity, the overall message in the US is that the housing market is reasonably robust. US corporate balance sheets are in their best condition for 15 years and whilst job growth has been sluggish, it appears that US companies can't keep cutting employment levels at the recent rate. Given how far employment levels have been trimmed, even lacklustre revenue growth is likely to provide stronger employment growth than we've seen thus far. Under this scenario, earnings should continue to grow and ultimately lead to increased investment, more jobs and further growth.

It is this virtuous circle of economic growth that the US is targeting and they are in the early stages of achieving this. The market will continue to weigh up the probability of success or failure in the US and whether actions by lawmakers or the central bank will help or hinder the process.

Locally our economy has proven to be flexible and resilient for a number of years. Saul Eslake at Merrill Lynch notes that the last recession in Australia (based on the standard definition) was in 1991 – a remarkably long time ago. He comments that since that time the US has had two recessions, the euro area three, the UK two, Canada one, New Zealand two and Japan six!

In December last year we wrote of the coming investment cliff as major projects in WA and Queensland draw to an end. Our economy is again entering a transition period. With a current budget deficit coupled with significant government and consumer debt, we will need the benefit of a low Australian dollar, low interest rates and some luck to ensure this transition is again relatively seamless.

The Quest portfolio has targeted holdings in companies with US dollar earnings. Investments in BlueScope, Stockland and the banks also provide some exposure to domestic cyclical activity, which we expect will eventually flow from lower interest rates in Australia. Domestic cyclical stocks have had a stop-start performance over the last 12 months as the challenges to the Australian economy have become apparent. With interest rates in Australia now at record lows and likely to head lower still, we continue to review additions to the portfolio in this area.

The Australian market has fallen around 8% from its high in mid-May. Valuations have dropped similarly with the average price earnings (PE) ratio for the market (ex resources) now sitting around 13.5x. This compares to the long-run average of 14.2x, as calculated by Macquarie Bank. With the weaker Australian dollar now providing a welcome tailwind and most analysts appearing to have only modest forecasts for growth, the upcoming full year reporting season in Australia should prove pivotal.

Note that industrial companies reported reasonable results in February for the first half of 2013. Earnings growth was achieved for the first time in a number of years with the highlight being the clear cost reductions made. If similar themes are reported in the full year results in August, the market can be expected to react positively given valuations and expectations are not currently demanding.

FEES

Given the strength of returns over the last 12 months, most clients have exceeded their previous high water mark, depending on the timing of the initial investment and any additional cashflows.

A performance fee for the March quarter 2013 has been deducted from the portfolio in this quarter. This fee reduced the overall return relative to the index for the June quarter. There is no performance fee due for the June quarter 2013.