QUEST

QUEST ASSET PARTNERS

QUARTERLY REPORT – MARCH 2015

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MARCH 2015

Mr John Citizen
123 ABC Street
Sydney NSW 2000

Account Name: Mr John Citizen

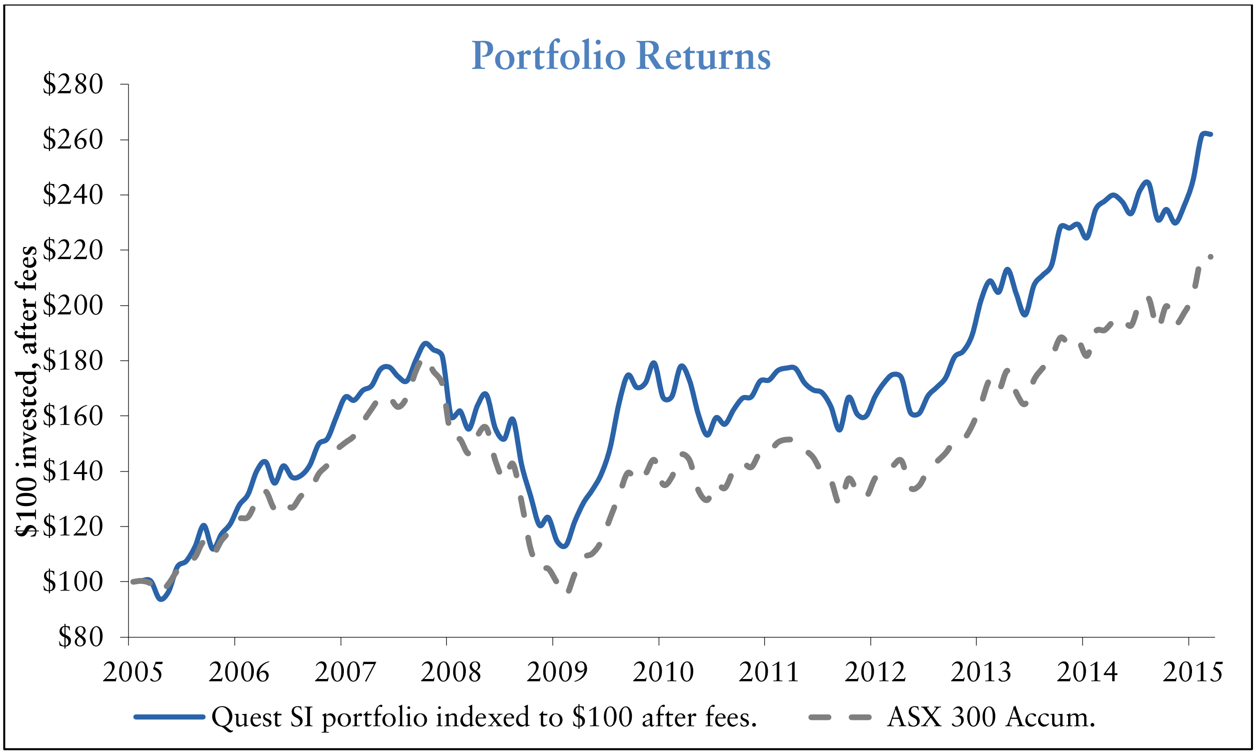
PORTFOLIO MOVEMENT	
Previous market value 31 December 2014	
Contributions during Quarter	
Portfolio movement*	
Market Value 31 March 2015	

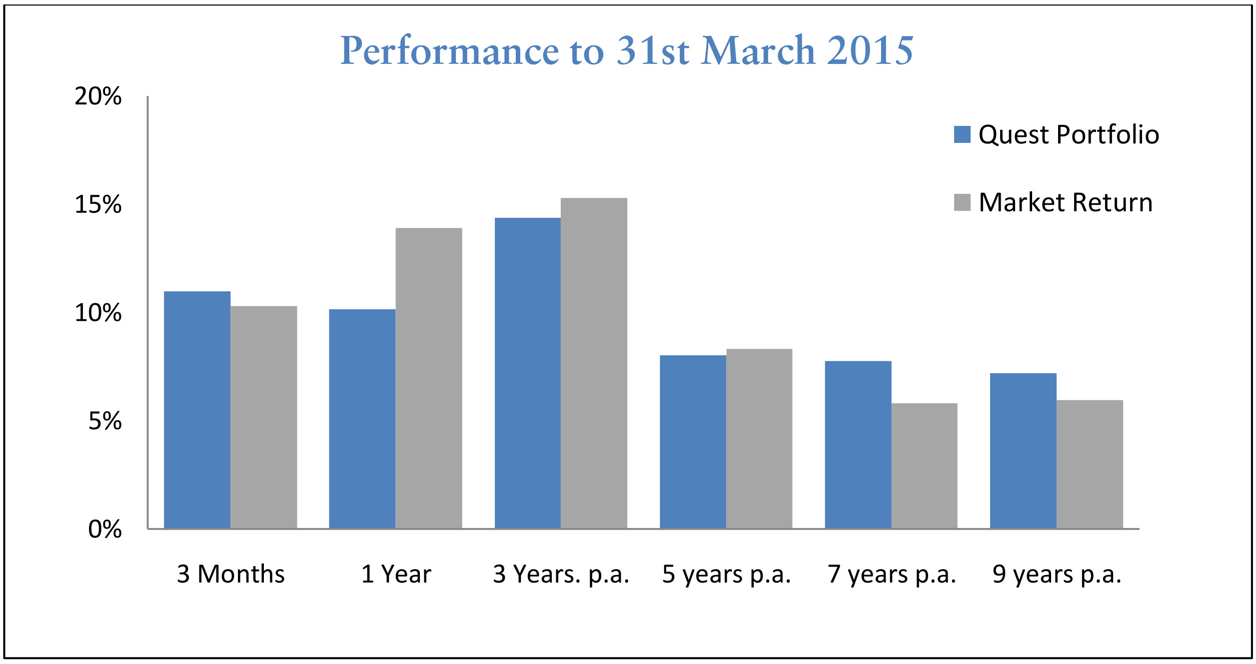
Your portfolio performance for the quarter*	11.03%
Market return (S&P / ASX 300 Accumulation Index)	10.31%

Your portfolio performance for the 12 months*	10.51%
Market return (S&P / ASX 300 Accumulation Index)	13.89%

* Includes fees for the period.

QUEST PORTFOLIO RETURNS*



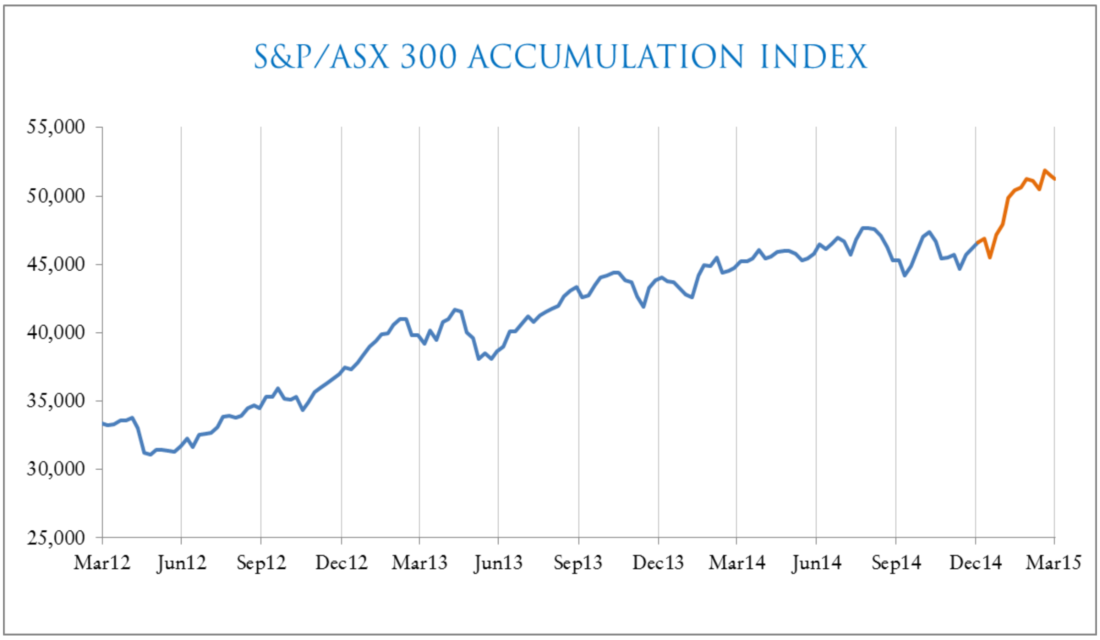


* The portfolio returns shown above are for an actual client portfolio. They demonstrate the returns achieved if invested in the Quest portfolio since inception (February 2005). Individual returns will differ for investors that made an initial investment after this inception date or where additional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

MARKET REPORT

THE ANNOUNCEMENT OF AGGRESSIVE MONEY PRINTING IN EUROPE LIT A FIRE UNDER GLOBAL EQUITY MARKETS. THIS WAS TRANSMITTED TO OTHER MARKETS AND THE US DOLLAR MOVED UP STRONGLY AS THE US CONTINUES TO MOVE TOWARDS HIGHER INTEREST RATES. THE QUEST PORTFOLIO PERFORMED WELL DURING THE QUARTER.

The Australian market performed very strongly in the March quarter posting a total return of 10.3%. This was the strongest March quarter return on record in Australia. The chart below plots the steady progress of the S&P/ASX300 Accumulation Index over the last 3 years, with the kick up from the last quarter clearly evident.



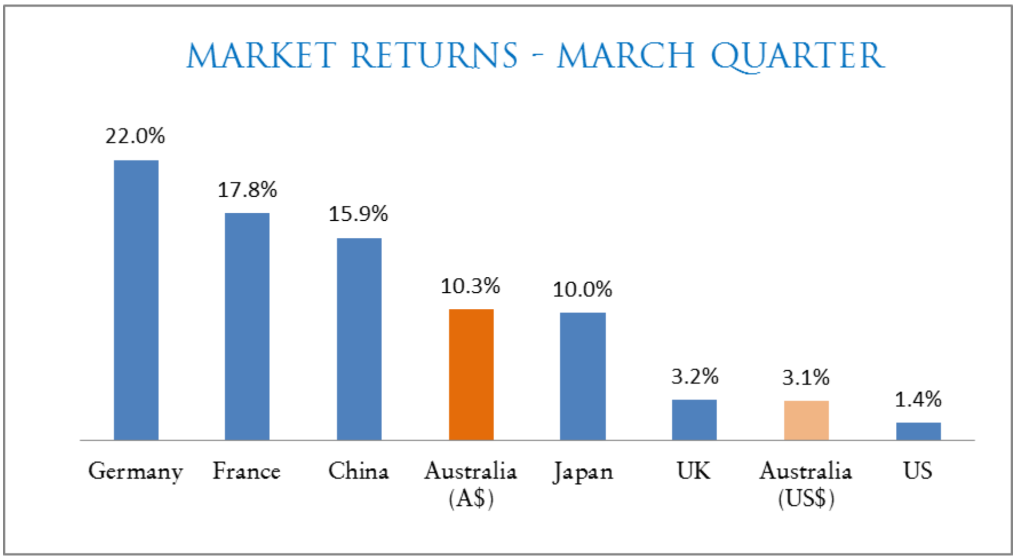
Source: IRESS

The banks, utilities and healthcare sectors were most favoured, whilst resources and energy stocks continued to struggle. The Quest portfolio performed very well, driven by some excellent individual stock returns, as detailed in Portfolio Activity.

Failing interest rates was the dominant theme during the quarter. The European Central Bank (ECB) announced a larger than expected programme of money printing in Europe during January (known as Quantitative Easing or QE) to counter the growing threat of deflation and stagnant growth. It had an immediate impact, sending global asset prices soaring.

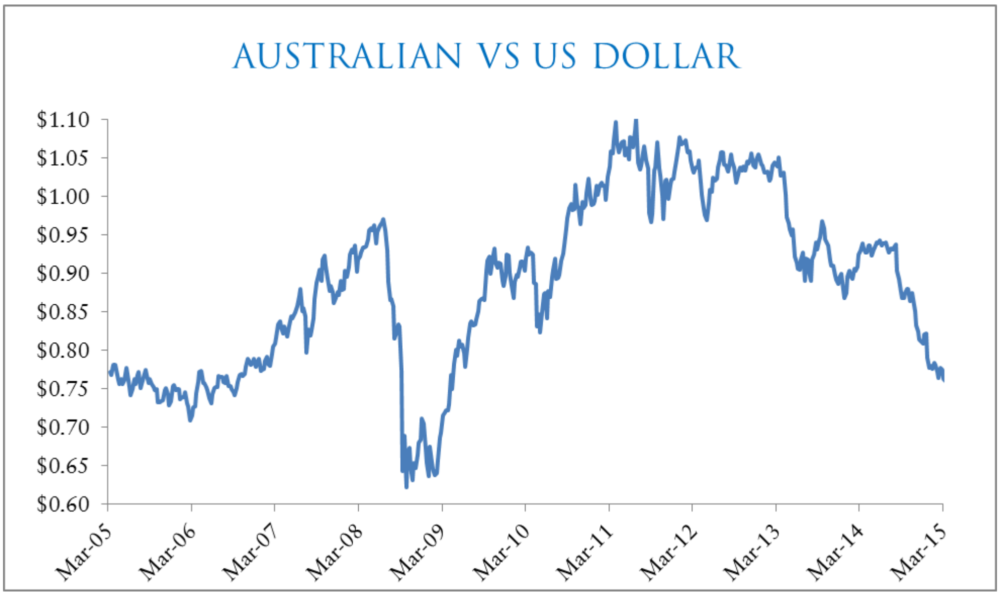
European equities were the biggest winners with German and French markets posting stellar returns. The RBA joined in, lowering the Australian cash rate to 2.25% at the February meeting, citing disappointing growth and the need to further stimulate economic activity. The following chart shows Australian returns against that of other major markets. The Australian equity returns exceeded both the US and UK markets by some margin but lagged Europe and China.

The other feature of the quarter was the extraordinary strength of the US dollar, against literally all the world's major currencies. The US Federal Reserve is now looking to edge interest rates higher while Europe, Japan and the UK are moving in the opposite direction through QE. The US dollar strength is therefore no surprise. This has widespread effects, not the least of which is to hinder US businesses competing in global markets. The corresponding weakness in the Aussie dollar has impacted market returns when seen from the perspective of a US investor in US dollars; the chart above highlights how the Australian market return falls from 10% to 3% when converted back into US dollars.



Source: IRESS

The weaker Australian dollar (down 7% for the quarter) is good news for many Australian businesses as competitiveness improves. Tourism and education, for example, should benefit as Australia now looks more attractive to international visitors. The chart below shows the extent of the recent fall in the dollar when viewed over the course of the last ten years. Quest benefits from investments that have overseas earnings and this contributed again to our returns in the quarter. The RBA remains very focused on the path of the Aussie dollar and continue to try to work it lower still.



Source: IRESS

Interim company profits were reported in February. Results broadly met expectations but some share price reactions were surprising. We saw both strong positive and negative reactions to relatively minor changes in earnings outlook statements. Overall, the market took this in its stride with February posting a strong return.

Capital management continues to be favoured with RIO, Amcor, Fairfax, Orica and Boral all announcing on-market buybacks during the quarter.

Merger and acquisition action included a $6.4bn bid by Japan Post for Toll Holdings said to be financed by very cheap Japanese debt and a chunky $1.4 billion recommended takeover offer for iiNet by TPG Telecom. Both stocks raced ahead. There was an agreed merger between two major real estate trusts in Federation (the old Centro Retail Trust) and Novion (formerly CFS Retail Trust) and a lower revised offer for miner PanAust by Chinese investor Guangdong Rising.

PORTFOLIO ACTIVITY

THE QUEST PORTFOLIO PERFORMED STRONGLY DURING THE QUARTER. HEALTHCARE, UTILITY AND BANK HOLDINGS CONTINUE TO DELIVER WHILST OUR ENERGY INVESTMENTS LAGGED THE MARKET. SIX NEW STOCKS WERE ADDED TO THE PORTFOLIO.

Against the backdrop of very strong global markets, the Quest portfolio performed well. We let the portfolio run as the market rose a prodigious 10%, making some small readjustments to the portfolio based on price movements. We also added APA, Ansell, TPG Telecom, Estia Health, G8 Education and Woodside to the portfolio.

There were no notable IPOs during the quarter but we do see some significant new offers being readied for debut in coming months. Quest's initial work suggests a couple of these look particularly interesting.

The portfolio made a significant investment in APA Group, scooping up some the retail shortfall from the whopping $1.83 billion capital raising that was launched in December last year. APA Group is the largest owner of high pressure gas pipelines in Australia with over 14,000 km of pipe assets. The raising was to acquire the QCLNG pipeline in Queensland from British Gas. The retail component was expected to produce a significant shortfall as the 1 for 3 terms weighed heavily on retail investors. APA is now a significant position for Quest. The stock has moved very well since, posting a gain of more than 20%.

Ansell was added to the Quest portfolio in February. Ansell was a valuation call after a good result. The updated guidance in February looked conservative to our team while the stock also benefits from a weaker Aussie dollar. The resultant increase in our target price saw us buy aggressively on the day of the result at $24. We also banked a 25 cent dividend soon after. This proved to be a timely purchase with Ansell trading up at $29 at the time of writing.

TPG Telecom was added to the portfolio in March. We are attracted to TPG's low cost and vertically integrated industry position. We believe TPG will continue to take market share in the consumer and corporate broadband market. The first half result highlighted TPG's strong cost focus as it realised synergies from the acquisition of AAPT. We expect similar cost discipline and significant EPS accretion if TPG is successful in its takeover bid for iiNet. Related to this investment is our steady reduction in our Telstra holding. Telstra now looks less attractive given the rationalisation going on in telco markets.

Villa World, a Queensland based affordable home builder, launched a placement at $1.90 to fund further land acquisition in January. Housing demand in Queensland is rampant and the company is looking to extend the supply inventory beyond five years. This initiative, whilst dilutive, de-risks the business and provided an opportunity for expansion in our valuation target. Villa World has upgraded earnings guidance a number times in the recent past and the February reporting season continued this trend. The raising fits our small cap life cycle theory and we note an increased retail interest in this stock, particularly from Queensland. At the time of writing, Villa World has moved smartly beyond $2.30 per share.

We have sold our holding in Regis Healthcare in March for a good gain and switched to Estia Health which is in the same sector as Regis but is relatively cheaper. We continue to like the demand drivers in this industry however we remain concerned about ongoing tinkering to government funding to the aged care sector. We think this risk is under estimated by voracious buyers and Estia looks to be the best value in the space. Regis was a good investment with an average entry of $3.70 from the float in October 2014 and an exit price around $4.40.

Minor additions were made to our positions in Vista Group, Orocobre, Ramsay Healthcare, iSelect, NAB and ANZ.

Given the big fall in early January, we added Woodside to the portfolio based on valuation. We have captured the interim dividend and look to an improved oil outlook later in the year to deliver the reward. A small position in Sundance Energy was added with the same theme. Like Woodside, this investment detracted from performance during the quarter but at the time of writing the oil sector is now showing early encouraging signs.

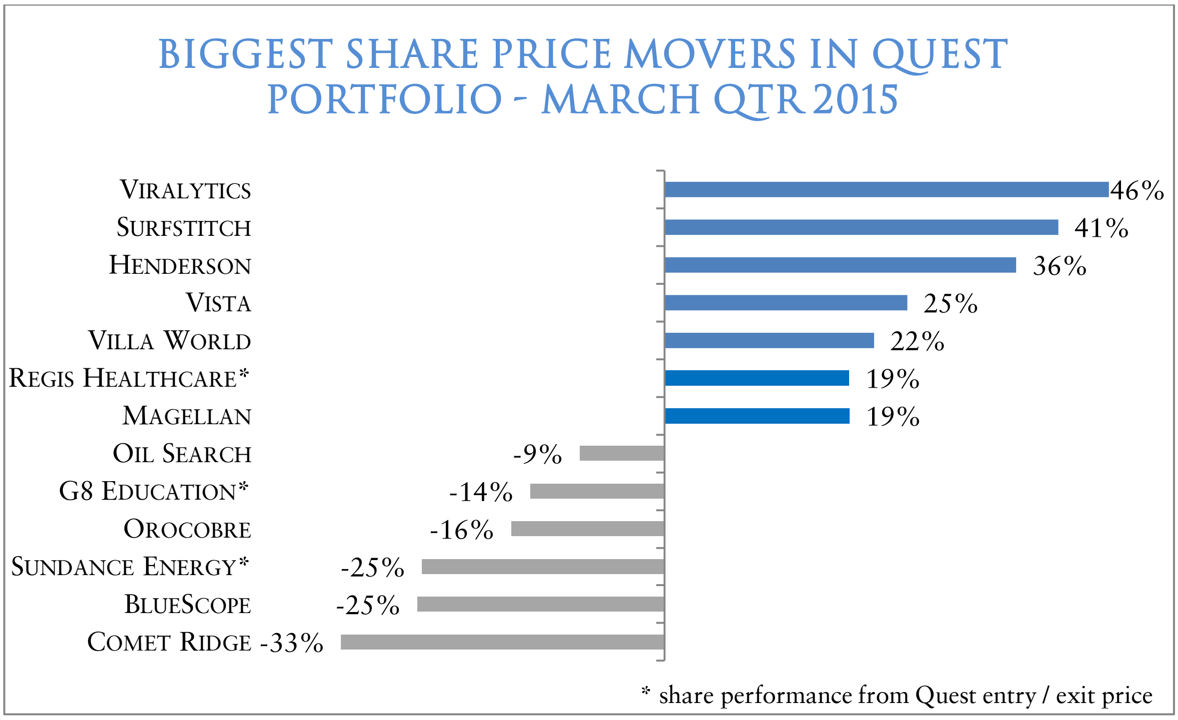
The position in travel insurance and medical assistance provider Cover-More was increased after the stock dipped post result. The result was not a disappointment in our view, rather the business is not well understood. We rate this stock an "A" and increased the holding cum dividend on a weak trading day at $1.81. The current price is around $2.10 ex a five cent dividend. Cover-More has only reported twice since listing in December 2013 and on each occasion declared a special dividend in addition to the regular dividend. We remain positive.

The Surfstitch Group holding was increased. Quest portfolios as a group own more than 6% of the company having bought pre IPO in August 2014 at $0.67. The float was at $1.00 in December and early trades were at a discount to float price. We bought more stock this year. The price is now above $1.30 with the stock up 37% in the quarter after a good revenue and margin result.

Wesfarmers was sold after reaching our price target. Veda was also sold after purchase back in 2014. We acquired the position via a sell-down by private equity player Pacific Equity Partners at $2.15. We saw this position as a short term holding and sold the stock profitably during January. Our holdings in Sydney Airport and Scentre Group were also sold profitably after reaching our price target.

We also exited RIO during the quarter preferring BHP at this time which is currently moving towards the spin-off of diversified assets in a new IPO to be known as South 32. There were also marginal reductions in Henderson Group and CBA during the quarter.

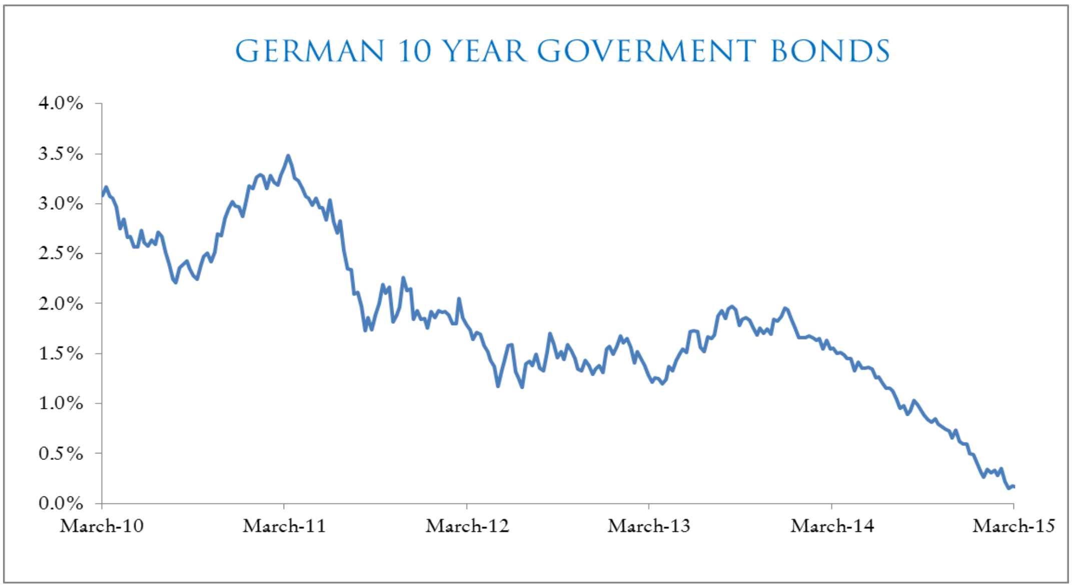
As mentioned, the Quest portfolio performed well in the quarter, outpacing the broader market. The chart below highlights the largest share price movements of individual stock holdings during the period.



OUTLOOK

INTEREST RATE MOVEMENTS GLOBALLY HAVE DRIVEN ASSET PRICES TO RECORD LEVELS. CURRENCIES ARE ADJUSTING AND GOVERNMENT POLICY WILL CONTINUE TO OVERSHADOW LOCAL ISSUES. OUR APPROACH IN THIS ENVIRONMENT IS TO IDENTIFY COMPANIES THAT CAN DELIVER EARNINGS GROWTH, A RARE AND VALUABLE ATTRIBUTE.

The quandary for market observers is whether the market is cheap or expensive given the recent rally in markets. Each argument has some validity. Price earnings ratios for many stocks are well above the average of the last two decades. Conversely, equity earnings yields continue to look attractive when compared to falling long term interest rates. Global interest rates are now at unprecedented levels; the chart below shows the extraordinary fall in German 10 year government bond yield over the last five years.



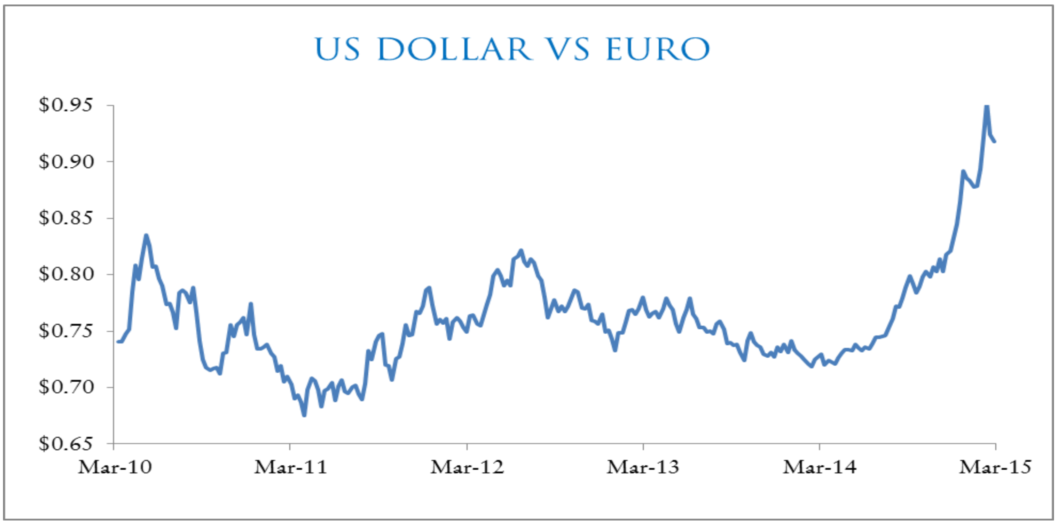
Source: Iress

Investors are now happy to earn an interest rate of only 0.14% pa for holding German government paper over 10 years; the lowest level on record. This fall has been mirrored in all European bond markets and its impact is now being transmitted to the rest of the world in one manner or another. For example, 70% of Euro 'investment grade' (a high quality rating) corporate bonds now have yields less than 1%. Further, investors have pushed sovereign debt into negative yields for German, Dutch, Austrian, Irish, Swedish, Finnish, French, Belgian and Swiss bonds.

Domestically, despite the fact mortgages can now be taken out at interest rates of less than 5% for the first time since the early 1960's, many expect the RBA to cut rates further. Like elsewhere, this cheap finance is driving up asset prices, particularly equities and eastern seaboard housing.

This is the primary motivation for authorities to undertake Quantitative Easing. QE delivers asset inflation which should lift aggregate wealth and ultimately stimulate investment and consumption.

As mentioned earlier, the US dollar rallied significantly. The following chart shows the extent of this strength against the Euro in recent months.



Source: Iress

The exchange rate is often the lubricant that adjusts to movements elsewhere. The appreciation of the US dollar has lowered the competiveness of the US significantly. Quest has previously written on this global currency war. With the Euro devaluing on the back of QE, European businesses such as Airbus are now more competitive against US-based businesses such as Boeing. Similarly, Siemens versus General Electric. In February, Brambles, who service a wide cross section of consumer and manufacturing sectors, reported a recovery in pallet volumes in European countries that were previously struggling. We may also be seeing the early signs of the impact of an appreciating US dollar on forecast US earnings. These forecasts will reduce partly as a result of the currency translation penalty incurred when bringing overseas earnings back to the US.

As a result, it was not surprising that the Federal Reserve significantly lowered their expectations for the speed of interest rate increases at their March meeting. The Federal Reserve can only raise short term rates to the extent that their economy can cope with a higher US dollar.

At Quest our portfolio has been conscious of the vulnerability of the Australian dollar for some time. We wrote an Insight on our web page in September 2012 suggesting the currency would fall although we were a little early; it did not roll down till April 2013.

Domestically, another factor is adding to the upward pressure in equities. As mentioned in Quest's March 2014 Report, Self Managed Super Funds (SMSFs) have had a significant allocation to cash since the GFC. There are now more than 545,000 SMSFs according to the ATO, with total assets of approximately $600bn. They are growing rapidly. The allocation to cash started falling during 2012 but still sits around 28%[1] and is the second largest asset allocation behind equities at 42%. As the RBA lowers interest rates, lower deposit rates have been driving SMSFs into property and equities. The defensive yield in stocks like CBA and Telstra has seen outperformance four years in a row.

How long can the market remain stronger for longer? As markets rise, the risks to capital preservation escalate. Whilst shocks can emerge from unexpected quarters, Quest is watching a number of issues that have the potential to change the momentum. Our focus is on wealth preservation as well wealth accumulation.

[1] CSFB, *The Selfies' income deficit*, 20th February 2015

As stated in previous Quarterly Reports, growth is hard to find and therefore increasingly valuable. As a result we have steadily been increasing the average quality of the businesses held in the Quest portfolio. This means we are now holding a higher proportion of “A” and “B” grade businesses in the portfolio than in recent years. In our view, these higher quality stocks are more likely to deliver reliable earnings growth in coming years as economic conditions remain tough. We also continue to bias the portfolio to benefit from a weaker Australian dollar.

FEES

Given this quarter’s performance, clients are likely to pay a performance fee (payable in the next quarter), depending on the timing of their initial investment and any additional cashflows.