Quest Asset Partners

Quarterly Report – September 2013

QUARTERLY REPORT
SEPTEMBER 2013

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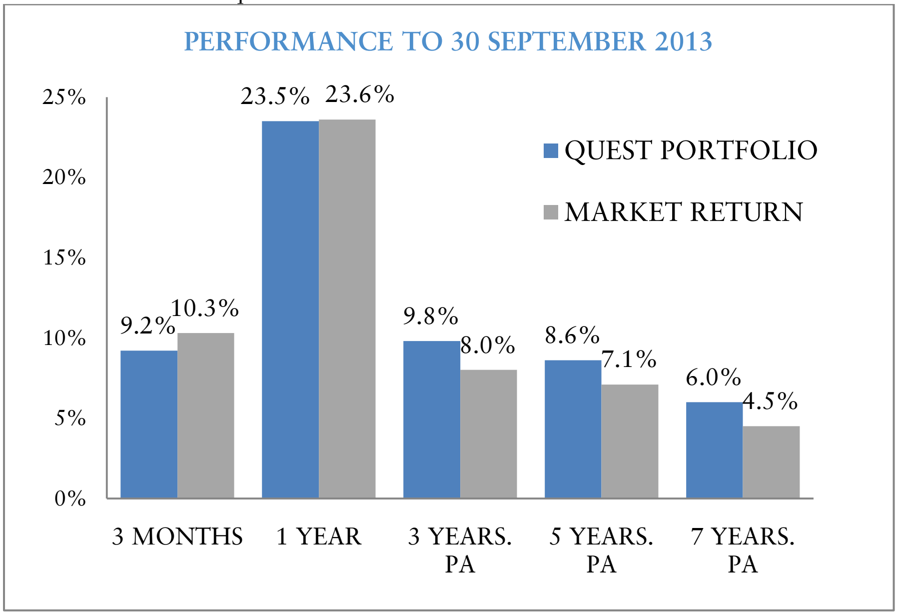
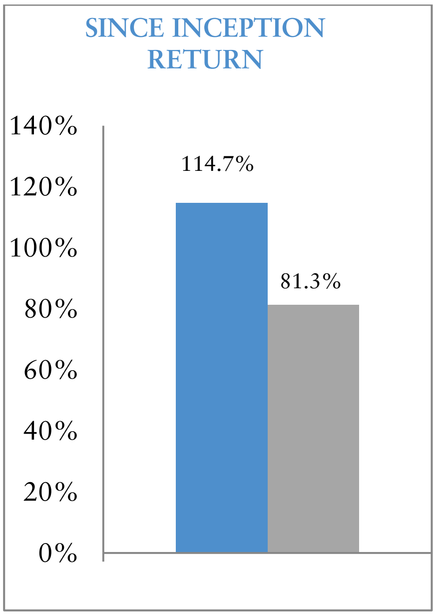
PORTFOLIO MOVEMENT – 30 SEPTEMBER 2013	
PREVIOUS MARKET VALUE 30 JUNE 2013	
CONTRIBUTIONS DURING QUARTER	
PORTFOLIO MOVEMENT*	
MARKET VALUE	

YOUR PORTFOLIO PERFORMANCE FOR THE QUARTER*	9.2%
MARKET RETURN (S&P / ASX 300 ACCUMULATION INDEX)	10.3%

*Includes fees for the quarter





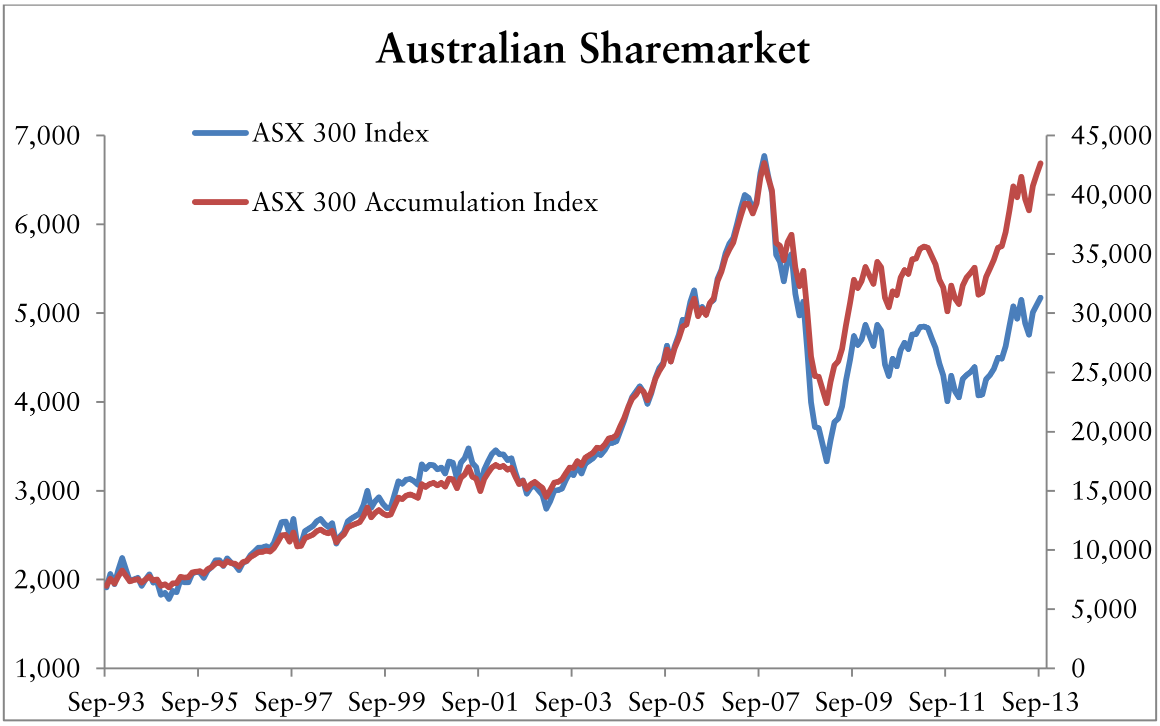
The portfolio returns quoted above represent the return achieved if invested in the Quest portfolio since inception (February 2005). Individual returns will differ for investors that made an initial investment after this inception date or where additional investments or redemptions have been made. Quest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

MARKET SUMMARY AND PORTFOLIO ACTION

A CRACKING QUARTER IN AUSTRALIA AFTER ANTICIPATED BOND TAPERING DID NOT EVENTUATE. REPORTING SEASON IS COMPLETE AND THE IMMEDIATE OUTLOOK LOOKS GOOD FOR EQUITIES.

The Australian market bounced back in the September quarter with a sizzling 10.3% return from the ASX300 Accumulation index. The same index hit a record high of 43,363 at the close of trade on Friday 27th September. The Australian effort was better than most global markets with the S&P 500 up 4.7% and the MSCI World index up 7.7%. An interesting move was the Euro Stoxx index which posted a lift of 11%, suggesting a sudden surge of optimism in Europe.

The Australian dollar rose 2% to $0.93, gold popped 5.8% to US$1,328/oz and oil was up 6% to US$102/barrel.The chart below compares the ASX300 to the ASX300 Accumulation index. If dividends flows are ignored (the blue line) the market is a substantial 23% from the peak achieved in 2007. This does not reflect the true position for the investor. The awesome power of yield over the last few years is clearly shown here. The Accumulation Index (the red line) is at new highs once dividends are added back to share price performance. This is the real benchmark return for the investor so the market is now in new territory.



Source: Iress

The recent financial reporting season in August was generally as foreshadowed in our June Quarterly. Investors were relieved to see few signs of a worsening economy and some signs of improvement. The industrial sector saw EPS growth of 5.2% while the resources sector EPS fell 27% in aggregate given weaker commodity prices and a persistently high dollar.

A feature of the season was that cost cutting and efficiency measures were adopted across most sectors. Companies delivered better margins than would have been expected earlier in the year due to cost cutting. The corporate sector is generally well positioned for any pick up in the economy and improved sentiment; margins could increase significantly under this scenario. The end of a prolonged electoral cycle in September has assisted sentiment with the latest NAB Business Confidence Survey recording a material improvement.

There was a lot of attention given to capital management during the results season. Investors have shifted from a growth bias to a more conservative capital preservation stance and company boards are very aware that there is little shareholder tolerance for holding capital in excess of requirements. Payout ratios are up and special dividends and buy backs are common amongst industrial names. Westpac, Woodside, GUD, Clough, Suncorp, UXC and Grain Corp all declared special dividends while CSL, Dexus, GPT, Hills Holdings, FOX, Macquarie, Qantas, Reckon, Resmed, Sigma, Westfield Trust and Westfield Group currently have buy backs in place.

In the September quarter the Quest portfolio did not keep pace with the benchmark returning approximately 9.5% before fees compared to the market at 10.3%. The Quest portfolio did however outperform the index over the 12 months to September by 4.1% before fees, slightly ahead of our adopted 4% target.

During the quarter the Quest portfolio added five stocks to the portfolio; Origin Energy, Sydney Airport, Magellan Financial Group, Qantas and Villa World. We sold our property trust (REIT) holdings in Stockland and Westfield Group.

Origin Energy reappears in the portfolio for the first time since 2009. Despite significant capital spending, particularly on the Gladstone LNG gas plant, the stock price has not moved much since then. The completion of that plant is now looming with the gas price looking very strong as Australia launches into an era of gas exportation. We see upside here on a three year view. The upside lies in the Return on Equity (ROE) uplift with first gas export in 2015 and the associated drop in capital spending. We see a target beyond $16 as achievable.

A recent fund raising and resolution of tax issues with the ATO has rerated Sydney Airport in our qualitative screens. The company issued new shares at $3.60 per share during the quarter. Shortly after, a major shareholder also sold a large holding. We took the opportunity to build a stake in this monopoly asset and see upside beyond the $4.00 level where the stock sits today.

Magellan Financial Group was listed in 2004 and manages offshore portfolios for local and offshore investors. The group has become a major local player in this highly competitive market with exceptional inflows. A sell down by a prominent local investor and our view that the Australian dollar will continue to fall prompted our interest. We also see a level of momentum in this business that could run on for some years. Like our holding in Henderson Group, Magellan shares will appreciate should the dollar fall from current levels. We believe investor interest in offshore equities will continue for some time. We see a return in excess of our 15% minimum requirement as achievable.

Qantas has performed very poorly in recent years. In October 2007 the stock peaked at $6 and recently flopped to a lowly $1.20. A classic “C” grade stock under our investment process, airlines are subject to international tensions, oil price fluctuations, natural disasters, currency movement and adverse economic events. Interestingly, the competitive dynamics have become more favourable recently. Growth in seat capacity locally has started to decline which should reduce the competitive pressure on ticket prices. Tiger Airways is now owned by Virgin so there is one less competitor. Free cash flow has recently turned positive. Yields should start to improve from here and the burden of capital spend (new planes) has come to an end. We regard the reduced capital spend to be a decisive driver of value.

Qantas domestic will be running only two aircraft types domestically in a few years rather than the current six. There is potential for asset sales. Our team concludes that all the negatives are widely known and reflected in the current low share price but that the positives are being neglected. The stock has not paid a dividend since March 2009 however a buy back is now in place. We are looking for Qantas to cruise above the $2 level in 2014.

We recently reviewed a number of home builders with particular interest in the embattled south east Queensland market. We believe this market has hit nadir. Villa World is a developer in Queensland, Victoria and NSW with a new management team and a solid inventory of house and land packages. The company has restructured over the last twelve months and has shifted emphasis to lifting sales, gaining share in the first home buyer market and developing more JV projects with land owners seeking assistance with development. Villa World has a volume based model and avoids customisation. The company carries significant tax losses but unusually is able to pay a fully franked dividend. Recently the company raised funds via a placement at $1.60 allowing us to gain a more meaningful position. The property market is moving in the company's favour with low interest rates, the end of the electoral cycle and an improvement in consumer confidence occurring at the same time. The Queensland market has been particularly hard hit and we see a good solid bounce in housing prices as likely in that region. Management are both experienced and focussed on carrying the company to the next level with minimal overhead. We have backed the new strategy and can see the stock delivering in 2014.

The Australian ten year bond rate has also risen since mid year. Our two REIT holdings, Westfield and Stockland, have been sold after reaching our price targets. Both stocks are defensive by nature and are now trading above net tangible assets. While Stockland still has a relatively high yield, we see the stock as being in a transitionary stage under new management for a while yet and the easy gains have been made.

Globally, we think the US Federal Reserve will commence bond tapering early in 2014. The decision maybe delayed due to the current concerns over the US government budget and debt ceiling issues. We have seen these issues before. In fact there have been seventeen US government shut downs in the past. We have no doubt that a resolution will follow a period of tense uncertainty.

OUTLOOK

THE QUEST PORFOLIO IS SHAPED FOR AN EQUITIES RUN INTO CHRISTMAS AND THROUGH TO MARCH LED BY A RECOVERING U.S. ECONOMY. WE OUTLINE BROAD THOUGHTS ON THE MAJOR REGIONS AND THE PORTFOLIO BY SECTORS.

UNITED STATES

We have visited the US twice this year and we are of the view that the economy is slowly improving. The recovery is sluggish but generally there are numerous positive trends. This is the world's biggest economy and we detected incremental improvement in a number of sectors.

The US Federal Reserve is spending $85bn per month buying US treasury bonds and mortgage backed securities which keeps interest rates low and hopefully stimulates economic activity. Chairman Ben Bernanke has signalled a possible reduction in these asset purchases, a process known as "tapering". This process will conduct market movements over coming months; the market is the puppet and the Fed holds the strings!

Home builders have seen significant increases in clearance rates and house prices this year. Builder surveys indicate sentiment to be at an eight year high. Retailing has picked up with a noticeable move to omni-channel strategies by established retailers. Industrial companies are seeing some improvement in outlook. The ISM indices were recently positive for both the manufacturing and non-manufacturing PMI. The recent quarterly reporting season delivered a timid but positive 3% growth in EPS for the S&P500. The unemployment rate is now down to 7.3%. Non farm payroll numbers continued to improve and the shale oil industry has created the potential for self-sufficiency as well as a major new export industry. Corporate balance sheets are in good shape too.

Once the US political impasse is settled, the tapering of Fed bond purchases will re-emerge. We do not see a shock and awe effect here, rather a gradual reduction in Fed stimulus over time which will lead to higher interest rates and a higher US dollar.

We have about 27% of our portfolio in stocks with US and offshore earnings at present. These include Computershare, CSL, FOX, Henderson, Goodman Group, QBE and Resmed. We see the US outlook improving and the Australian dollar declining in 2014.

EUROPE

In the June quarter GDP growth was positive 0.3% after six quarters of negative GDP growth. The European scene remains uninspiring other than the remarkable election win by Angela Merkel in September whose Christian Democratic Party won more than 40% of the vote but still need a coalition party to govern as a majority. Germany continues to be the engine room in Europe but it is hard to see any dramatic economic improvement short term.

Our only European exposed stock of significance is Henderson Group which has been a terrific performer, up over 50% since January. Lend Lease has developments in the UK that will deliver revenue from 2015.

AUSTRALIA

The painfully long electoral cycle in Australia has concluded with early signs that business confidence is improving. The NAB Confidence Survey for August jumped by the 5th largest margin since the series started in 1988 and is back to average levels. Housing markets are improving with high clearance rates in major centres. The improvement in house prices is just what the Reserve Bank is looking for: higher existing dwelling prices lead to more new housing activity as existing dwellings become more expensive. In fact on the day of writing the Housing Industry Association has released August 2013 figures indicating “clear upward momentum in both new home sales and building approvals for detached houses”. The best states were NSW and Western Australia. The major home builders are reporting increased enquiry rates too. This is good news for the economy and great news for state governments who are receiving much higher stamp duty receipts than expected.

We are positive on domestic cyclicals as business confidence is rebuilt but the potential uplift in stock prices may be more mooted than for offshore earners. We have about 20% of the portfolio in domestic cyclicals including Blue Scope, Boral, Caltex, Lend Lease, Qantas, and Sydney Airport.

The resource industry is dependent mainly on China but also Korean and Japanese customers. We are currently seeing rising volumes on steady prices in most key commodities for the major players. After gyrations in the iron ore price last year, this year has been stable with iron ore still holding above $130 per tonne. Even at $100 per tonne, Australia’s major stocks, BHP, RIO and Fortescue have fat margins with cost of production at less than half that number. The capital spend budgets are declining now for the majors and we expect larger dividends from these companies from 2015. We are less optimistic on smaller resource stocks due to their higher production costs.

We hold only 3% of the portfolio in mining stocks being lithium producer Orecobre and gold miner Doray Minerals. The resource weight will increase if stock prices ease. We are particularly negative on aluminium, nickel and coal and hold no exposure in these commodities.

Retail is still struggling with consumer caution but recent figures show some improvement. It could be low interest rates, increased certainty post the election, unseasonal warm weather or some other factor that suddenly makes the consumer more enthusiastic. There appears to be a continuation in the trend for consumers to spend on food and experiences at the expense of merchandise from the big names such as David Jones and Myer. The good news continues to be online where internet retailing continues to see prices falling on rising volumes which is keeping Australia Post and logistics companies busy. We see retailers as fully priced at this time.

Our portfolio has no retail exposure at present.

Banks are the leading source of fully franked dividends in our market and a large component of the portfolio. Recent share price performances have been stellar from the big four. Lending growth remains sluggish in a subdued economy however cost cutting programs and technological advances together with lower funding costs have allowed consistent generation of record profits.

We hold 26% of the portfolio in banks for the yield but have reduced our positions as prices have risen.

Quest has three oil and gas stocks being Oil Search, Origin Energy and Woodside with the latter soon to be disposed. We see upside in both Oil Search and Origin both of which are in the final phase of developing major projects that are close to completion. The outlook for gas pricing is positive. Both stocks have off-take agreements in place. Oil Search has been in our portfolio for years while Origin is a more recent addition.

Quest carries 6% of the portfolio in Oil Search and Origin shares.

At end September the cash level in the portfolio was 12%, well above our average cash level of around 4%. The higher level of cash is held in anticipation of a pullback in the market in September. This correction is now playing out in October.

In the September quarter the Quest portfolio returned less than the benchmark. The market return was 10.2% while our portfolio returned 9.5% before fees. Our holding in coal seam gas player Comet Ridge was the main culprit trading at 15c at the close of business at 30th September 2013 having traded as high as 24c during the quarter. Our entry price is 11c and our valuation is above 30 cents. Comet's interests are mainly in Queensland and as such are not affected by the regulatory issues in NSW. We expect the stock to do better from here.

Our one year performance is 4.1% ahead of the benchmark before fees, slightly above Quest targets.

FEES

There is no performance fee payable this quarter.