QUEST

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QUARTERLY REPORT
DECEMBER 2008

John Citizen

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PORTFOLIO MOVEMENT – DECEMBER QUARTER 2008	
PREVIOUS MARKET VALUE 30 SEPTEMBER 2008	
CONTRIBUTIONS DURING QUARTER	
PORTFOLIO MOVEMENT*	
MARKET VALUE 31 DECEEMBER 2008	

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

*Includes fees for the quarter

MARKET SUMMARY

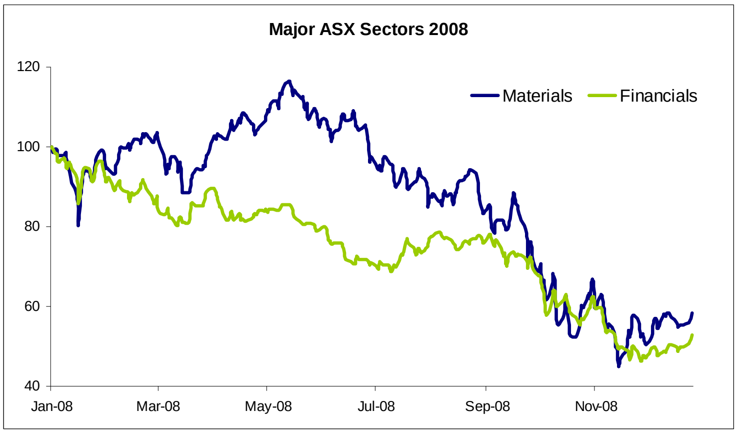
The December quarter saw extraordinary events that resulted in a major collapse in confidence in the global financial system. Stock markets tumbled amidst the uncertainty. In the USA, Merrill Lynch was sold to Bank of America, Washington Mutual to JP Morgan and Wachovia to Wells Fargo. Morgan Stanley was bailed out by Mitsubishi UFJ. The US Fed invested $US85B into global insurer AIG.

In the UK, the Bank of England nationalised Northern Rock and Bradford & Bingley and injected equity into Royal Bank of Scotland, HBOS and Lloyds. The Irish government bailed out Allied Irish, Bank of Ireland and Anglo Irish Bank. In Europe, Fortis and Dexia are both surviving on government funding while Hypo Real Estate was rescued by the German government. Iceland went broke as the banking system collapsed.

The benchmark ASX 300 Accumulation Index fell 18% during the December quarter. The full calendar year result for the benchmark ASX 300 was down 39%. The worst performers globally were Russia (down 74%), China (down 65%), and India (down 56%).

The ASX 300 finished the year a massive 43% lower than the peak in early November 2007.

The uninspiring performance of the Financials and Materials sectors during the year are shown below.



InTech research indicates that, while equities were not rewarding in 2008, Quest has performed better than most in a very poor environment. In fact, InTech reveals the Quest composite result has achieved top quartile performance over 1 year, 2 years and 3 years. The InTech rankings of 67 managers place Quest at 7th over 1 year, 7th over 2 years and 1st of 67 managers over 3 years.

While these rankings bring no relief to investors who have endured a miserable year in equities, Quest is now establishing a track record of beating the benchmark in both bull and bear markets.

PORTFOLIO ACTIVITY

New investments during the quarter included Worley, which is a provider of engineering services to the energy, resources and infrastructure industries. Operations are based in Sydney but conducted on a global scale. The rapid decline in stock price during 2008 from an extravagant $52 to below $20 sees the stock under our valuation for the first time in over two years.

Felix Resources was purchased after a major price correction saw the stock at a discount to our valuation. Felix is a Queensland and NSW producer of semi soft and thermal coals. In 2008 the company produced 4.6 million tonnes of coal and made a profit of $188 million after tax, albeit at higher coal prices than exist today. We believe the Felix coal mines are of a strategic value that is higher than current market prices.

We made small profitable trades in National Bank and AMP post new equity raisings. Quest also accepted the Westpac bid for St. George on behalf of our investors and as a result now holds an increased position in Westpac Banking Corporation.

We also accepted the $5.75 cash bid per share for Queensland Gas from British Gas in October. Queensland Gas has been a spectacular investment for clients who initially bought as low as $1.41 in March 2007 with an average entry price of $1.65 inclusive of additional purchases. The return has been 250% in less than two years. Yes we are trying to find another one!

RIO was sold after the BHP bid for RIO was unexpectedly withdrawn. Our investment hypothesis was that this deal would occur and we were surprised by the withdrawal of the bid, particularly as BHP had spent over $400 million in pursuing the merger.

Cash at year end was just over 1%.

OUTLOOK

The key international issue for 2009 is the integrity of the US economy; whether the enormous stimulus programs are capable of reversing the current economic decline. The US consumer will be the key indicator and the effectiveness of government fiscal stimulus should become apparent in the first quarter.

We remain optimistic that at current levels the market is pricing a very high level of negativity, and that while upside is hard to estimate, the downside from this point does appear limited given the massive correction in 2008. The market is now 43% below the November 2007 peak. Interest rates in Australia have already been slashed 3% in four months to 4.25%. Further rate cuts are expected, probably in February, which will cause a shift in accumulated cash to higher yielding investments including shares. Depositors that were earning in excess of 7% in cash are now struggling to get 5%. There is therefore a high likelihood of a cyclical and/or yield rally in the first months of the new year.

We expect the usual new year rally in January before the half yearly financial reporting season gets underway in February. This month could be turbulent. Disappointing results will be harshly dealt with in this environment. Apart from the earnings outlook, the ability to secure credit is essential to maintain operations. It is already apparent that larger companies with stronger cash flows are securing credit more readily than smaller companies under pressure from tougher conditions. Banks are deliberately rationing credit to better customers. This volatility may create some good buying opportunities, particularly in smaller stocks.

The resource boom is over with consequences for Australia's exports in 2009. There is minimal clarity on volumes, demand and pricing at this time. The fortunes of the eastern states are therefore more important than last year. The state of the NSW economy is very weak, borrowing over $10 million per day just to maintain the current rate of decline. Receipts are slipping as tax collections fall and stamp duty collections diminish. NSW will however benefit from the dramatic 3% fall in interest rates in recent months. Fuel prices have eased dramatically and the state should benefit from the upcoming Government infrastructure program.

The Quest portfolio has been defensive over the last few months but we are now lifting our exposure to cyclical stocks. A defensive portfolio in this environment would suggest that the massive fiscal stimuli being used around the world will fail; this is a risky assumption given the size of the stimulus.

Our bank holdings were increased as we sold out of resources mid-year with the intention of finding better opportunities elsewhere. While this was a good move in hindsight, we struggled to find enough attractive new stocks to buy which has resulted in the higher bank holding.

Banks have found it difficult to raise debt in offshore markets and have been raising capital to repair their balance sheets. The result has been a continuing flow of dilutive fund raisings that are sacrificing shareholder wealth in the short term, hopefully to build a better bank for the long term. IFRS accounting standards are delaying the inevitability of balance sheet write downs but we expect reality to hit the banks as lower property prices are recognised in the June and December reporting periods. The conundrum with banks is that, while the outlook is mediocre, the sector has already fallen dramatically and a recapitalisation program is well underway.

The major banks have raised $9 billion from the market since mid November! ANZ is the only major not to have raised capital.

Quest continues to favour healthcare stocks, holding CSL (blood products and vaccines), Primary (GP medical and pathology practices) and Sonic (global pathology). All are below our valuations but are less cyclical and thus more defensive than the broader market.

The outlook for insurance is improving with the prospect of higher premiums in 2009. QBE is our favoured stock.

The falling interest rate environment may result in some cyclical rotation in the first months of the new year. Banks will have some cyclical response if that occurs. In addition, we have added JB Hi Fi to the portfolio. The company is an electronic retailer with over 110 stores. Store locations are in lower rent locations. An average JB Hi Fi customer spends under $100 per visit so the company is well placed for any consumer led recovery.

Our holdings in the Australian Stock Exchange, Australian Wealth Management and News Corporation also give us cyclical exposure as does Leighton which will be a beneficiary of the government infrastructure package due in the March quarter.

Origin Energy continues to be a major stock in our portfolio. We still see upside in this company, particularly from the Coal Seam Gas prospects in Queensland. The arrival of Conico Philips as a joint venture partner in 2008, together with large commitments by British Gas (took over Queensland Gas) and Petronas (JV with Santos) to the region will see billions spent on well development, pipelines and port infrastructure over the next five years.

Our small cap industrial stock holdings are 6% of the portfolio while another 6% is in small resource stocks. Small stocks as a sector have fallen 56% this year! Valuations were just too high but we are now finding heavy selling is providing opportunities. It is possible that the half year reporting season in February will provide a catalyst for the smaller stocks that can demonstrate sustainability after these huge price falls. Our small industrials include Australian Wealth Management (financial services), Charter Hall (property), Dolomatrix (waste services), JB Hi Fi (retail), Seek (recruitment) and Walter (engineering services).

We continue to maintain holdings in small cap resource stocks including Beach Petroleum (oil and gas), Citadel Resources (gold) and Felix Resources (coal). All are trading well below our Quest valuations.

The new calendar year should see an increase in takeover and merger activity as buyers emerge in search of discounted assets. We expect to see service providers and mining companies absorbed into larger entities during the year.

FEES

No performance fee was earned during the December quarter.

Clients should note that a high water mark was established last year with respect to any potential performance fee. This means that no performance fee will be earned until the portfolio value exceeds the high water mark and the performance hurdle is met.

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