QUEST

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QUARTERLY REPORT
SEPTEMBER 2008

John Citizen

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PORTFOLIO MOVEMENT – SEPTEMBER QUARTER 2008	
PREVIOUS MARKET VALUE 30 JUNE 2008	
CONTRIBUTIONS DURING QUARTER	
PORTFOLIO MOVEMENT*	
MARKET VALUE 30 SEPTEMBER 2008	

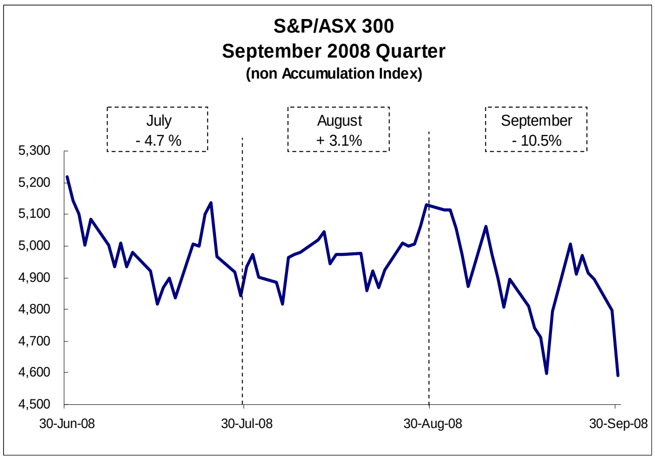
YOUR PORTFOLIO PERFORMANCE FOR THE QUARTER*	
MARKET RETURN (S&P / ASX 300 ACCUMULATION INDEX)	

*Includes fees for the quarter

MARKET SUMMARY

Concern and frustration during the September quarter resulted in extremely challenging and volatile markets across the globe.

As the credit crisis deepened, a string of bank failures and rescues followed in both the US and Europe and it became apparent that the US economy was at risk of systemic failure. Recognising this, the US Government put in place unprecedented measures to "unlock" the financial system and to inject much needed confidence into the US and global markets. Markets reacted violently as these various mechanisms were debated and enacted.

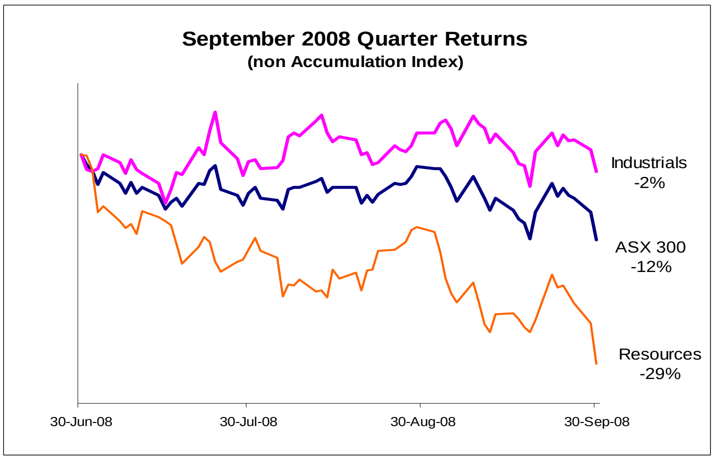


Evidence of further slowing in China combined with weakening of the US and European economies is driving concern that the global economy is heading towards recession.

Against this backdrop, the S&P/ASX 300 Index fell 12% during the September quarter.

Markets were again polarised with resource stocks heavily marked down as global growth expectations were reduced. Oil was down 28% and all major commodities were sold lower. Small resource stocks were hit particularly hard.

By contrast, the Financials Index was flat and the Industrials Index was down only slightly during the quarter.



Amongst the heaviest hit resource stocks were some of the strongest performers from last quarter such as Fortescue
(-61%) and Incitec Pivot (-45%). The selloff was indiscriminate with RIO (-37%) and BHP (-28%) both severely discounted despite their high quality, diversified portfolio of mining operations that produce robust cash flow.

The Australian dollar fell very heavily during the quarter (to 79c from 96c), assisting companies with substantial US dollar earnings. Investors were drawn to those stocks with stronger balance sheets. Beneficiaries included QBE +21%, Woolworths +13% and CSL +5%.

Businesses with heavy debt burdens continued to be shunned. Poor performers included Babcock & Brown (-74%), Suncorp-Metway (-24%) and GPT (-19%).

PORTFOLIO ACTIVITY

The Quest portfolio outperformed the market returning approximately -8.3% (before fees) for the September quarter. The ASX 300 Accumulation Index returned -10.7%.

Our view was that the best investments in this environment would prove to be those businesses with strong franchises, excellent management, strong balance sheets and ideally pricing power. We refer to these businesses as “A” grade.

We took the opportunity to increase our holdings in high quality businesses trading at or below our valuation. In bull markets “A” grade businesses typically trade well above our valuations. In these conditions that situation has reversed. Our portfolio now comprises almost exclusively “A” and “B” grade businesses (over 90%) and is at a higher proportion than at any time in the past.

We also reduced our exposure to the resource sector (now about 30% of the portfolio) and continued to favour larger companies over small (small companies now comprise less than 20% of the portfolio).

Cash was relatively high early in the quarter but was reduced to 2% as investments were made.

We increased our holding in CSL to 5% of the portfolio and benefitted from its strong performance during the quarter.
QBE, Woolworths, CBA and SAI also contributed solid returns.

Following the bid from ConocoPhillips for Origin’s coal seam methane assets, we increased our Origin holding to be one of our major portfolio positions.

We see excellent value in Origin at current market prices given it is now effectively debt free, has a strong domestic business and has valuable strategic options for the sale of its excess gas.

Importantly, little value is being ascribed by the market to Origin’s extensive coal seam methane assets - the same assets that ConocoPhillips has agreed to pay up to $9.6 billion to develop in JV with Origin.

New investments during the quarter included ASX (an A grade business now within our valuation range), ANZ (one of the most heavily discounted major financials) and WDS (pipeline/mining services business expected to be a beneficiary of the coal seam methane boom in Queensland).

During the quarter we exited investments in OneSteel, Macquarie Bank, Connect East, and Herald Resources after the conclusion of a drawn out takeover.

OUTLOOK

The immediate outlook for financial markets has never been more uncertain but we remain optimistic. The local market has largely priced in a severe outlook.

The biggest global issue is the implementation of the US Government initiative – Troubled Asset Relief Program or TARP. While the internal workings of TARP remain unknown, it can succeed if it provides a floor price for distressed assets and allows the credit and banking system to again function normally. This market desperately needs an injection of confidence to convince shell-shocked investors that it is again safe to invest. There are cashed up buyers out there who need to see some catalyst before being prompted into action.

Locally, our banks are the key to our market. They have been pushing through a major storm and are beginning to emerge safely. Remember that there are over 200,000 banks globally and only 18 carry an "AA" rating. Four of those are in Australia!

Further write downs of poor quality assets are likely and only those high quality players will attract funds. Depositors will continue to move cash to banks that are perceived to be less risky and further capital raisings can be expected.

From all this, the stronger banks will emerge with a solid capital base, more customers and attractive prospects. Consolidation is now occurring and this is the time to pick your bank holdings with a three year view. Our preferred banks are Commonwealth Bank, Westpac and St George (soon to be Westpac via takeover).

Broker analyst earnings forecasts for 2009 and 2010 still remain too high, in our view. Both revenue and margins are forecast to increase in what will be a difficult economic climate and interest expense estimates are too low. Balance sheet analysis will be back in style by this time next year as an obsession with earnings growth gives way to earnings quality and stability.

The small cap sector overall will remain troubled with earnings forecasts still looking optimistic. Historically in bear markets, small caps get trimmed as the market falls. Initially profits are taken, in the secondary phase they are sold down to a price to make room for larger liquid stocks and finally small caps are abandoned and randomly sold as their significance wanes. The opportunity for investors is post the abandonment stage which is yet to come.

Some months ago the oil price was dinner table conversation, the Australian dollar was well above 90 cents against the USD and interest rates were expected to rise to combat inflation. Today oil is under $90 per barrel, the dollar is below 75 cents and interest rates are falling.

Our portfolio does not take a strong view on oil at present (we own BHP and Beach Petroleum) however we continue to carry exposure to the emergence of coal seam gas as an energy source via Queensland Gas and Origin. The coal seam market is consolidating and this will continue.

The fall in the Australian dollar means offshore earnings are now more valuable measured in Australian dollars. Our portfolio is protected from this event by holdings in companies with offshore operations such as CSL, Sonic Healthcare, News Corporation, QBE, SAI Global and United Group.

The property sector will be in a state of recovery for years. We have looked for value here unsuccessfully as excessive debt and the need to sell in a falling market make a period of prolonged consolidation a certainty. Those sitting on cash waiting to buy property assets are going to enjoy the coming months!

The resources boom has peaked and is effectively over. Global growth is disrupted and optimistic assumptions on base metal prices are no longer justified. Our portfolio holds only the major companies exposed to coal and iron ore; BHP and RIO. We have avoided screen traded commodity stocks (copper and zinc etc) for two years and it has now paid off as prices collapse. BHP has proposed to take over with RIO and we will see this deal moving into a new phase when the European regulators decide the fate of the deal in January. We believe this merger will occur.

Investors who are feeling frustrated, humbled, confused or stumped are not alone. There is no precedent for the current situation but it will move to another phase. The seeds were sown in August 2007 and we are now into the second year of rehabilitation.

Quality companies with good management, strong cash flow, pricing power, barriers to entry and reasonable debt will be the better performers. We believe our major positions fulfil these requirements and that this is a time to be patient for the portfolio to deliver in this new environment.

FEES

No performance fee earned during the September 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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