QUEST

QUEST ASSET PARTNERS

QUARTERLY REPORT – SEPTEMBER 2014

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SEPTEMBER 2014

Mr John Citizen
123 ABC Street
Sydney NSW 2000

Account Name: Mr John Citizen

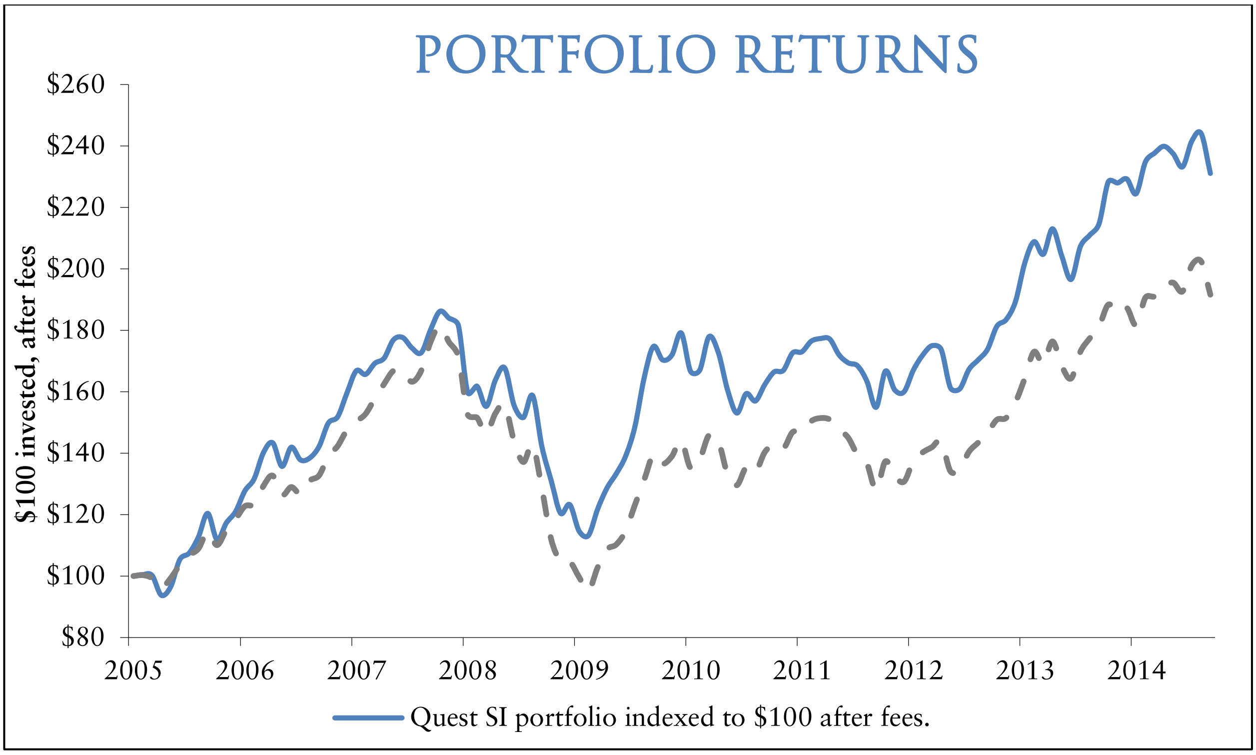
PORTFOLIO MOVEMENT	
PREVIOUS MARKET VALUE 30 JUN 2014	
CONTRIBUTIONS DURING QUARTER	
PORTFOLIO MOVEMENT*	
MARKET VALUE 30 SEP 2014	

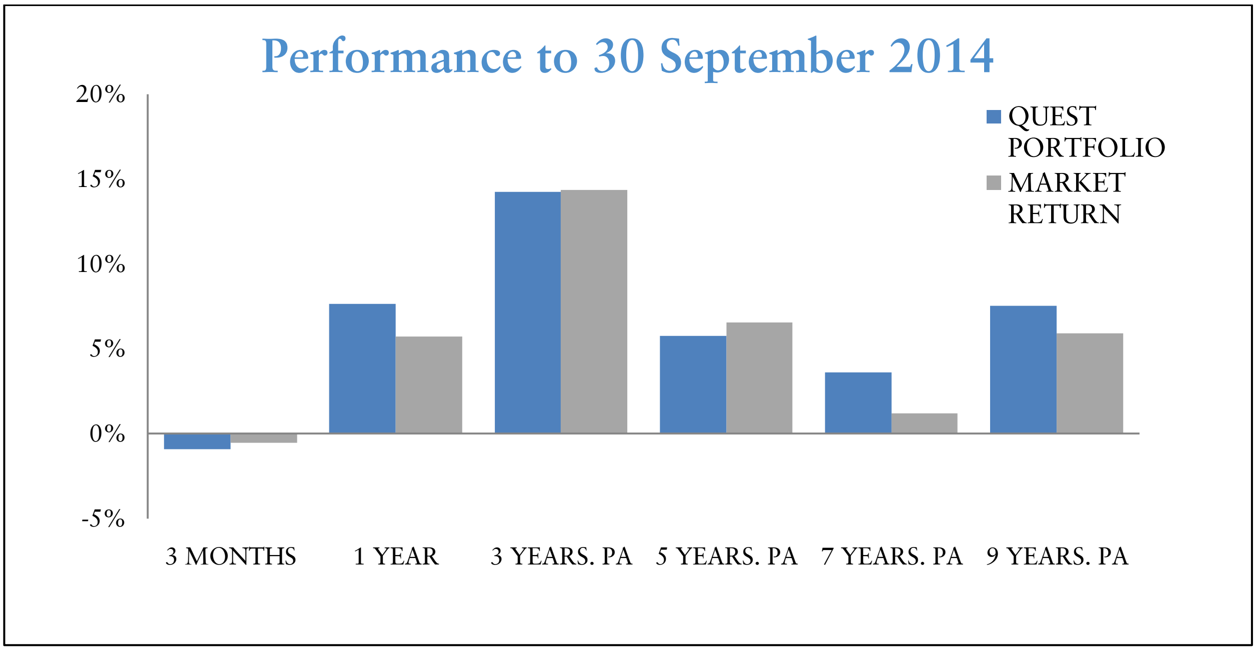
YOUR PORTFOLIO PERFORMANCE FOR THE QUARTER*	-0.91%
MARKET RETURN (S&P / ASX 300 ACCUMULATION INDEX)	-0.57%

YOUR PORTFOLIO PERFORMANCE FOR THE 12 MONTHS*	7.88%
MARKET RETURN (S&P / ASX 300 ACCUMULATION INDEX)	5.73%

* 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

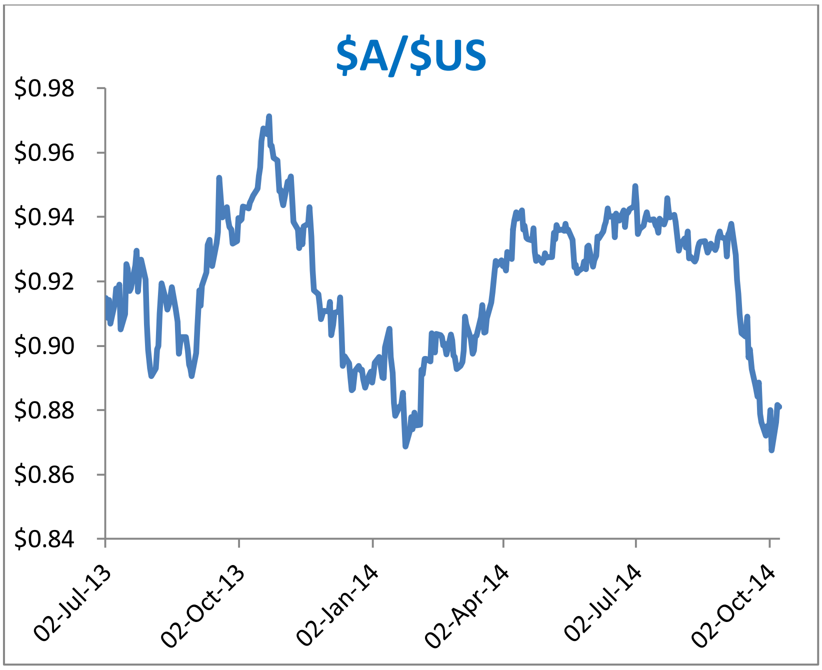
MARKET REPORT

AFTER A STRONG START, THE AUSTRALIAN ASX 300 ACCUMULATION INDEX FINISHED DOWN 0.5% AS THE MARKET CORRECTED IN SEPTEMBER.

The fall in September was exacerbated as offshore investors responded to a severe slide in the Australian dollar by selling heavily across the board including previously favoured yielding stocks. The banks corrected with Westpac the worst down 8.3% in the month of September while CBA fell 7.4%. In comparison, the US S&P 500 rose 0.6%. European markets were weaker than the US with the FTSE 100 down 1.8% for the quarter and the German DAX down 3.6%.

During the quarter the $A fell over 7% in comparison to the US dollar, with the reduction of US quantitative easing (QE) finally resulting in the anticipated strengthening of the green back. The Annual Economic Policy Symposium at the end of the northern hemisphere summer at Jackson Hole, Wyoming was the turning point. At the symposium Fed Chair Janet Yellen suggested that ultra low interest rates are still needed to boost the US economy. This saw a short rally but it did not take long for sentiment to turn again toward the likelihood of higher rates as the US economy continues to improve.

With concern about rate rises in the US, further signs of economic weakness in China, a flat economic outlook in Australia and a floundering iron ore price, the Australian dollar finally capitulated and tumbled to levels not seen since February 2014. Stocks went with it, erasing earlier gains in the quarter.



Source: IRESS

Events in Europe were however shaping up differently. The European Central Bank announced the start of their own form of QE (purchasing Asset Backed Securities, ABS), just as the US were bringing the same strategy to an end. Emerging concern over the European outlook and an upcoming stress test of banks, which may lead to recapitalisation of some banks, has seen sentiment swing to the negative once again. The Euro, like the Aussie dollar, fell 7.7% against the US dollar. These are dramatic falls by the Australian dollar and the Euro in such a short period.

In our previous quarterly we warned of "a strong feeling of contentment" and the potential for volatility ahead. This volatility has now arrived. The theme has now been picked up by the assistant governor of the Reserve Bank Dr Guy Debelle in early October who also warned of dangerous complacency in financial markets. The comments attracted a lot more attention than our observation back in July!

Interestingly, all of this has not reduced the affordability of a European holiday for Aussie tourists. The dollar has only fallen 0.5% against the Euro in the quarter.

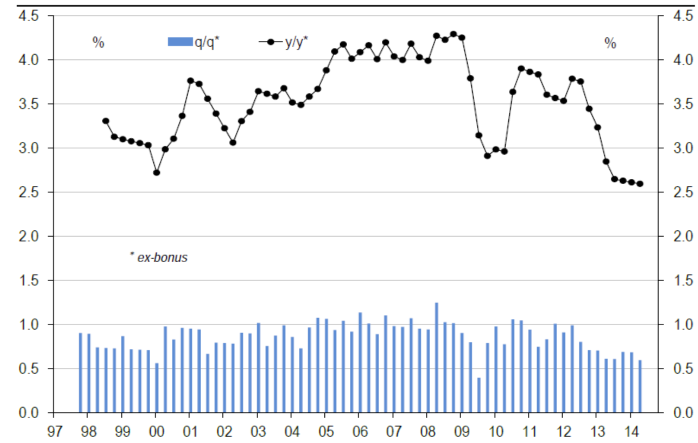
Locally, the reporting season for the six months to June 2014 was largely positive. Few larger stocks disappointed and the market again saw short covering by hedge funds in many stocks where the market had low expectations. Significant themes Quest noted during reporting season were:

- The market remained yield driven
- Higher dividends payouts but lower earnings growth
- Poor revenue growth
- Success of new business models / disruptors
- Falling interest costs
- Small cap downgrades outnumbered upgrades
- No bank earnings upgrades this time.

Significant sales growth was again hard to find. Goldman Sachs recorded only eight stocks where their analysts revised sales expectations higher. The high payout ratios were again notable. Industrial company payout ratios are now close to 80% of profit. Whilst this is what the market has sought, it does limit the capacity to fund growth.

The following chart shows a major reason for poor sales growth. Wage growth is at the lowest level in more than 15 years, rising 2.6% in the year to June 2014. Consumers are concerned about job security, Federal budget cut backs and falling commodity prices. The RBA Board has now left the cash rate at a record low for 13 months. The RBA are envisaging a repositioning of the economy away from a heavy dependence on mining investment (exports) to higher consumption. At the same time we need to avoid a housing bubble. This repositioning has some way to go with mining investment forecast to bottom in 2016 and no sign of improving consumption. Lower cash rates and a lower $A are key variables in ensuring the transition is gradual and not unstable. The RBA are not known for wild celebrations but they must be celebrating (in their own economist's way) the support the lower $A provides the local economy.

Wage Price Index slows to 2.6% year on year



Source: ABS, UBS

The RBA has noted in recent minutes the lack of response to lower interest rates and particularly the lack of 'animal spirits' in the economy. The RBA wants to see increased investment and consumption in the economy to replace the slump in resource investment. Low interest rates are vital to investment in sectors other than mining. So far however, corporates have just continued to build cash and pay dividends. Bank credit figures suggest they are not investing while households remain cautious.

PORTFOLIO ACTIVITY

A NUMBER OF POSITIONS WERE SOLD AND NEW POSITIONS ACQUIRED; THE AIM BEING TO INCREASE PORTFOLIO BUSINESS QUALITY AND GROWTH EXPOSURE.

Holdings in Origin Energy, Toll, Woodside, Ansell, Greencross, Silex and OzForex were exited and the bank weight was lowered by selling the ANZ holding. These sales occurred early in the quarter as price targets were achieved, or as new data emerged. This funding was redirected into new positions.

As we have recorded in the last few quarterly reports, global markets have seen a surge in new float activity or the "Initial Public Offering" (IPO). Whilst Quest has invested in only a few of the many we have reviewed, we have found a number of opportunities particular in the healthcare sector. Growth is an increasingly rare commodity in an economy requiring restructuring. Healthcare delivers growth with a regularity not found in many sectors. Investors are paying more for the growth that is available. We believe this trend will continue and healthcare will be one of Australia's few growth sectors.

The areas where Quest has confidence of growth over the medium term are in the following sectors:

- Healthcare
- Disruptors in financial services
- Education with an emerging Asian middle class and COAG reforms providing opportunities for private operators
- New business models arising from software as a service (SaaS) and 'big data'

The float and timing of Healthscope provided a significant opportunity to reposition the portfolio with a larger healthcare exposure. For some time we have been following the success of private hospital operator Ramsay Health Care but valuation has continually been an issue. The float of rival Healthscope provided an attractive entry point for both to be added to the portfolio. Many clients will be familiar with the consumption habits of an ageing population. Healthcare is one of the few categories to rise as older Australians step down their retail consumption.

Healthcare is now more than 10% of the total portfolio weight and includes the long held position in blood products manufacturer CSL, together with private hospital providers Healthscope and Ramsay, aged care provider Regis, Viralytics in oncology and iSelect with their health fund comparison business.

Last quarter we took profits in recent aged care IPO Japara Healthcare post significant price appreciation. Subsequently another aged care IPO, Regis, was added to the portfolio, with a better quality portfolio and we believe a better position to execute on the huge requirement for aged care beds. Regis is rated a 'B' grade due to a significant portion of revenue from government funding, although recent legislative changes have improved the investment opportunities for good operators.

Vista Group was added to the portfolio, also via IPO. The primary listing is in New Zealand, and this relatively small business of 300 employees is the world's largest supplier of cinema ticketing software with a global share of more than 35%. Interestingly, Australasia leads the world in cinema ticketing and loyalty systems. Our channel checking confirmed a premium position in both mature exhibition markets in the US and Australia and also leading positions in emerging markets like Mexico, Argentina and China. Vista has grown their global position with a strong focus on product development and is currently investing significantly in the use of sales data to help clients improve movie marketing. This 'big data' investment has potential to outstrip growth of the cinemas in emerging markets, with movie houses and exhibitors currently poorly positioned to focus their vast movie marketing dollars.

It is rare for Quest to rate a new IPO as an 'A' grade, but both Healthscope and Vista received 'A' grade quality ratings. The above investments and changes mentioned in previous reports have raised the portfolio's 'A' and 'B' grade aggregate weight to approximately 80% over the last few months.

Quest has also taken a small position in internet retailer SurfStitch ahead of their IPO, expected in late 2014.

CONTRIBUTION

The portfolio performed in line with the benchmark during the quarter. We are disappointed with this as one small investment – Arrium – which we have subsequently sold, has offset many good performances. Arrium fell significantly when they raised $750m at a discounted price to offset a gearing squeeze from the plunging iron ore price.

The following table shows the best and worst contributors relative to the benchmark. You will notice the contribution from a number of our smaller businesses including iSelect. A new CEO was appointed to the company in March which has brought improved operational focus to the business. Market sentiment has lifted with a clearer corporate vision and a greater understanding of the operating leverage and growth prospects. CSL continues to deliver while Lend Lease has now breached $15 relative to our entry price of $7.95.

Lithium producer Orecobre will move into production during the next quarter.

Best	Poor
CSL Ltd	Arrium
Healthscope	BHP
Cover-More Group	Doray Minerals
Orocobre	Vocation
Lend Lease	ANZ Bank
iSelect	Commonwealth Bank

FEES

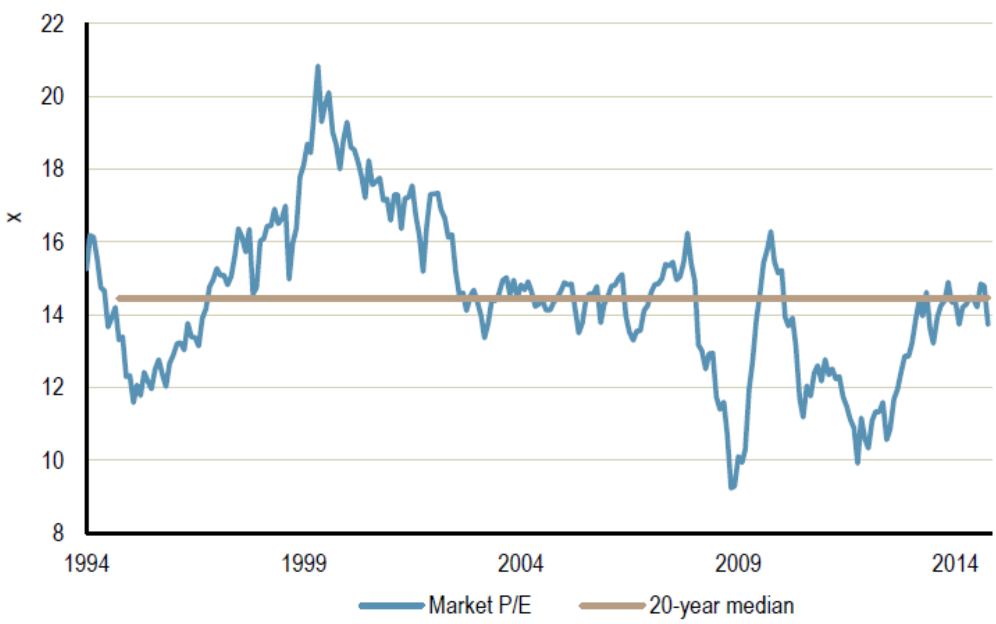
There is no performance fee payable this quarter as high water marks were not exceeded.

OUTLOOK

THE MAJOR ISSUE FACING SHORTER TERM EQUITY RETURNS IS THE TRANSITION TO HIGHER SHORT TERM INTEREST RATES IN THE USA.

The first step by the US Federal Reserve was the scaling back of the monthly bond purchase program; this will be complete before Christmas. The next step, expected sometime in CY 2015, is for short term US interest rates to rise. A shift in trajectory has often historically been accompanied by equity volatility. The local market saw a pullback in September to prices that are more supportable and the higher cash balances during seen during the quarter were invested early in October. Whilst the next few months may provide some turbulence, local gearing is low, balance sheets are in good shape and the RBA is working to reposition the economy. The following chart from UBS shows the Australian market is now trading a little below the average PE. We view the current correction as healthy having warned in the prior quarterly of complacency. Our team has found numerous new opportunities in the current environment; we are not overly concerned about the market correction given that 7 of the last 10 quarters have seen the market reach higher levels.

Figure 11: P/E of the Australian Aggregate Market



Source: I/B/E/S, Datastream

CHINA REVIEW

IN MID SEPTEMBER QUEST VISITED A NUMBER OF CHINESE BUSINESSES, BANKS AND THE BANK REGULATOR TO ASSESS ECONOMIC CONDITIONS IN CHINA

The Chinese economy is undergoing significant reform. The new leadership has increased the pace of reform to shift the economy away from the present fixed asset investment and SOE dependency. Whilst economic reform is significant, other policy reforms such as foreign policy action and another push against corruption are placing strains on the bureaucracy. In addition, the recent demonstrations in Hong Kong highlight the new leadership's potential to revert to a policy of control despite the significant emergence of a Chinese middle class seeking more independence.

Regarding economic reforms, the government is attempting to balance the reform agenda on the one hand and not see significant slowdown from current lower levels of economic growth. Our impression is the risks continue to be to the downside.

Finance in China is hard to find. The banks have quota limits that are restricting advances and so small finance companies are booming, lending at rates of 20-30%! Whilst Australia has few peer to peer lenders, China has more than 1,200. We met with two of the rapidly emerging lenders and saw few signs of credit control. The Bank Regulator is currently undertaking stress testing of the banks. They were more worried about confidence than property loan default. Manufacturing appears currently to be the biggest issue in non-performing loans. The high cost of short term finance is placing strain on businesses and investors across the spectrum.

Property prices may have seen their worst, with recent government policy initiates to support some of the worst areas. No one we met expects a strong price recovery but ongoing urbanisation will consume excess supply. The ability to release the current credit quota limit is one lever available to the government.

The present policy to restructure the economy whilst also ensuring the Chinese economy does not weaken significantly is likely to be in place for a few years and confirms our view that our resource positions must be focused in the lowest cost producers ie BHP and Rio. These stocks are not necessarily long term holds. The current environment is also not conducive to investment in small resource companies at this time.