

Lodestar Australian Strategic Share Fund

Monthly Investment Report

June 2011

Lodestar Capital Partners Pty Ltd is a dynamic specialist Australian equity manager, founded in 2005. Lodestar's focus is on delivering sustainable investment returns over the long term by applying its extensive experience and skills, within a nimble structure that enables it to seize opportunities.

Market Review

John Morgan, Chief Investment Officer, Lodestar Capital Partners

- The S&P/ASX200 Accumulation Index fell 1.8% in June as the market remained preoccupied with global growth concerns and the eurozone sovereign debt crisis. Earnings risk continued to feature during June as downgrades outnumbered upgrades three to one with analysts factoring in the higher \$A, domestic consumption moving offshore and repercussions from local natural disasters.
- Locally economic data continued to suggest a slowing of the Australian economy. Australian employment data for May showed a lower than expected gain in jobs, the fifth downside surprise in the last six months, whilst interest rate futures priced out any chance of a rate hike this calendar year. The RBA held rates steady but continues to stress the longer term inflation challenge.
- Economic data from the US continued to point to weaker hiring, slowing manufacturing and a decline in consumer confidence. Housing starts rose faster than expected, although this is from an extremely low base. Housing made up 17% of US GDP in 2005 and is now only 2.5%. Oil prices weakened after President Obama announced he would be releasing supply from the US Strategic Petroleum reserve to relieve price pressure.
- Markets remained concerned as to Greece's ability to meet austerity targets as a prerequisite for further loans but this abated as Germany and France relaxed their stance on timing of repayments. It would appear for the time being there is a commitment and will to maintain the eurozone in its current form. However the broader longer term issue of indebtedness remains.
- The Peoples Bank of China raised reserve requirements for the sixth time this year. However the Chinese economy is now clearly slowing with activity indicators (GDP, industrial production and fixed investment) and consumer indicators (retail sales, vehicle sales, consumer confidence and real per capita urban income and consumption) all adding to the weight of evidence the economy is slowing. There is a growing expectation the next move will be a policy loosening in the months ahead.

Fund Performance

Period ending 30.06.11	1m %	3m %	1yr %	2yr % p.a.	3yr % p.a.	Since Inception % p.a.
Total Return	-1.01	-2.90	-0.18	7.40	-2.08	-0.32
90 Day Bank Bill*	0.40	1.22	5.00	4.43	4.81	5.54
S&P/ASX 200 Accum^	-1.80	-4.02	11.73	12.44	0.32	-1.06

Standard Deviation [#]	
Fund	12.96%
S&P/ASX 200 Accum	16.93%

Performance returns are calculated net of management and performance fees and are pre tax. Past performance is not a reliable indicator of future performance, the value of your investment can go up and down.

* 90 day Bank Bill rate resets quarterly and is used for the purposes of calculating the performance fee.

^ S&P/ASX 200 Australian Shares Accumulation Index is provided for comparison purposes due to the Australian Share investment focus of this Fund. It is not the Fund's benchmark.

Rolling 3 year annualised using monthly returns.

Inception date 1 March 2007.

- The Fund produced a return of -1.0%, outperforming the S&P/ASX 200 Accumulation Index which fell 1.8% over the period.
- Sectors that were reduced were Energy, Resources, Industrials and Consumer Discretionary. One sector where exposure was increased was Banking, an increase which was executed late in the month.

Positive Influences

Company	June Return %	Fund Position %
CBA	3.26	6.9
Emeco	6.39	2.1
Southern Cross Media	6.67	2.6

- CBA retraced most of the previous month's loss as funding cost concerns eased post the partial resolution of the Greek crisis.
- Emeco had been oversold and represented excellent value at the beginning of the period under review.
- Southern Cross Media rallied strongly having been oversold during the capital raising undertaken for the Austereo acquisition.

Negative Influences

Company	June Return %	Fund Position %
Telstra	-4.40	5.1
Newcrest	-5.10	4.1
UGL	-9.87	1.5

- Telstra fell over the month after the announcement of the governments proposed NBN, including terms which were not as positive for Telstra as some had been hoping. The Fund's position was built in March when Telstra was trading around \$2.70, and has benefited given the subsequent price increase, even factoring in the June decline.
- Newcrest, the Funds largest Resource position, produced a negative return as the overall Resource sector sold off over the month.
- United Group fell on concerns around contract performance however the Fund had taken affirmative action reducing exposure to the stock early in the month.

Outlook

The local sharemarket on historic measures is fundamentally good value. The Price to Earnings ratio for the Australian market is currently 13 times for the financial year ending 2011, and if forward earnings are used this ratio falls to around 11 times. Aside from the December quarter 2008, this is the lowest level in 20 years.

When inflation is taken into account the sharemarket is at one of its cheapest points in over 20 years. The gearing of the corporations that make up the S&P/ASX200 are at multi-decade lows, with analysts needing to go back to the early 1980's to find comparative low levels of gearing. The sharemarket is historically cheap on both an absolute and inflation adjusted basis, and the level of balance sheet debt is low further lowering the financial risk of the asset class. Thus the importance of positive and secure earnings becomes paramount in this environment.

The forward earning expectations are for 17% growth in FY12. This is likely to be too high given the domestic and international settings at this point in time.

Why is the market reflecting such good perceived value? The sharemarket does not give bargains for free. There are sufficient macro risks to the global economic growth profile to emphasise this point.

- The U.S recovery from the GFC is underway but remains fragile relative to other post war recoveries from recession. The lack of job recovery remains an unresolved problem even after the efforts of both the massive monetary and fiscal policy initiatives. The fragility of the recovery has been clearly seen with activity indicators such as the Purchasing Managers' Indices falling quickly following the impact of the Japanese tsunami through its disruption of imported intermediate goods.
- The European sovereign debt crisis has clear echoes of the GFC about it. The latest iteration to resolve the seemingly impossible mathematics of the Greek debt balance has the jury adjourned with eyes still very much tied to the ratings agencies' response, the Portuguese and Irish bond rates and the political environment in Germany.
- The Chinese are addressing their inflation concerns, in particular food and property prices, which has bought about a slow down in their economy. The main instrument used has been the banking systems reserve requirement ratio, which now stands at 21%. This is now 3.5% higher than the peak of 17.5% in 2008.
- The Australian Reserve Bank seems to have clearly reached the pivotal point in the monetary tightening cycle with consumer spending seemingly stopping after the November hike lifted rates to 4.75%. However the RBA commentary remains hawkish in threatening to push rates higher. In addition, the minority Government in Canberra has produced a combination of unannounced policy detail and general timidity that has unsettled business and consumer confidence alike. The response from both elements of the economy is a continuation of the "new austerity" with private sector credit growth running at decades lows.

With this backdrop it is difficult to see certain companies growing revenues and margins as anticipated over the next 12 months.

However the U.S recovery is still underway, despite being insipid versus other post war recoveries, and the most recent data seems to be pointing to the Japanese earthquake as the main cause of this mid-cycle slow down. The second Greek bailout may prove to be a workable plan to deal with not only the Greek debt but also Portuguese and Irish default fears. Meanwhile the key economies of France and Germany continue to grow at reasonable rates. The Chinese Premier Wen Jiabao has clearly stated a change in thinking on monetary policy direction with his June statement. It is similar in importance to the one announced in late December 2009 when he declared the commencement of the tightening cycle.

In Australia, the yield curve is now flat and is effectively ruling out another tightening for the RBA for the foreseeable future. Politically, there is apparently going to be clarification announced in the near term on the carbon tax and eventually the resources tax. If all significant negative factors are resolved, then the sharemarket can resume the pattern it has established since 2009 of trading between 4400 and 5000. It is at the bottom of this range at the moment and is attempting to rally after holding this level recently with the fear of Tokyo being evacuated due to the meltdown of the Fukushima nuclear facility in April and the narrow avoidance of a Greek no confidence vote in their Parliament, effectively allowing them to remain in the European Union in June.

Next we face the Australian and U.S reporting seasons to shed light on the corporate realities of the two-speed Australian economy and the fragility of the U.S recovery. The previous reporting seasons in both the U.S and Australia have been received well by their respective markets. In general, this is likely to occur again.

There will always be some "land mines" going off and it wouldn't be reporting season without them, but if the recent May conference at Macquarie is any reflection, it should be reasonable and is likely to give the market a level of underpinning on valuations. This will produce a foundation for which the market can build.

With the macro settings limiting the absolute level of growth, with low levels of credit growth reflecting a new conservatism in both corporates and consumers, the most likely course for the sharemarket is the course it has been on - a range bound market between 4400 and 5000. At the moment there has been some good news received after a wave of bad. We are at the bottom of the established trading range currently, and we anticipate a rally.

The strength of the eventual rally will be informative for investors' future expectations into 2012 and beyond.

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