

Lodestar Australian Strategic Share Fund Monthly Investment Report

August 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 1.91% in August, the fifth consecutive monthly decline, and finished the month at its lowest level since July 2009. However the Australian market fared better in local currency terms than other major markets with the S&P500 down 5.7% over the month, the FTSE100 off 7.2%, the Nikkei 225 falling 8.9% and the MSCI APEX 500 down 9.7%.
- Markets were buffeted by deteriorating prospects for growth and fiscal stability in the developing world, with the latter being highlighted by a downgrade of the US sovereign debt rating by Standard & Poor's. There is an increasing lack of confidence in governments being able to create sustainable recovery from their current fiscal positions. Weaker leading indicators only highlighted the macro headwinds facing investors. These increasing economic concerns and a subsequent move to risk aversion saw the local Resource index fall 5.2%. Commodity prices were mostly lower with base metals and oil reflecting the global growth risks, although iron ore continued to be resilient.
- The US Congress passed a measure to raise the Treasury's borrowing capacity, with this move followed soon after by Standard & Poor's decision to downgrade its rating on US federal debt. Despite this US Treasury yields fell to record lows on weak economic data. The European Central bank began buying Italian and Spanish bonds pushing their yields lower and reassuring markets concerned that these countries bond markets may follow the course of their Greek cousins.
- Locally the Reserve Bank highlighted mounting global uncertainty in its decision to leave rates unchanged in August. However they would have also been heavily influenced by very weak domestic data with house prices, credit data and retail sales all remaining soft whilst building approvals and employment fell further. Consumer confidence numbers fell to levels last seen in mid 2009.
- The Australian currency was volatile over the month, trading in a large band and giving up some ground from its July post float high.
- The earnings results season dominated corporate news flow in August. Resource stocks results were generally slightly below forecast on higher costs whilst Industrials were generally higher. Significantly company outlook statements were subdued and reflected a high degree of uncertainty. Capital management initiatives (buy-backs) increased and dividends were higher than forecast. Stronger than expected sales growth was offset by declining margins due to higher operating costs and a stronger Australian dollar.

Fund Performance

- The Fund produced a return of -0.67% for the month of August, outperforming the S&P/ASX 200 Accumulation Index which fell 1.91%.
- Over the month the net market exposure was increased from 77.7% to 87.0% as the valuation of the market became more compelling.
- Metals and Mining exposure was decreased from 19.6% to 17.1% whilst the Oil and Gas exposure was exited.
- Bank exposure was increased from 21.9% of the fund to 24.4%.
- Health Care was increased from 2.4% to 4.5% whilst the remaining REIT exposure was exited.
- The Telecommunication exposure was increased by 1%.

| Period ending 31.08.11 | 1m % | 3m % | 1yr % | 2yr % p.a. | 3yr % p.a. | Since Inception % p.a. |
|--------------------------------|-------|-------|-------|------------|------------|------------------------|
| Total Return | -0.67 | -4.08 | -3.10 | -1.59 | -4.94 | -1.00 |
| 90 Day Bank Bill* | 0.42 | 1.25 | 5.03 | 4.59 | 4.65 | 5.52 |
| S&P/ASX 200 Accum [^] | -1.91 | -7.51 | 1.92 | 2.04 | -1.44 | -2.33 |

| Standard Deviation [#] | |
|---------------------------------|--------|
| Fund | 12.55% |
| S&P/ASX 200 Accum | 16.76% |

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.

Positive Influences

| Company | August Return % | Fund Position % |
|-------------------------|-----------------|-----------------|
| Telstra | 5.7 | 6.2 |
| Silver Lake Resources | 24.4 | 0.9 |
| Alacer Gold Corporation | 14.7 | 0.9 |

- Telstra outperformed for most of August before profit taking hit the stock late in the month following the ACCC announcement relating to the NBN. The ACCC's preliminary view on the splitting of the company associated with the NBN was that Telstra's structural separation undertaking did not address legislative requirements and changes were needed. The company's FY11 result came in ahead of consensus while the full year dividend was in line with guidance.
- Silver Lakes Resources and Alacer Gold Corporation both rallied strongly as the price of gold hit an all time high in mid-August, with gold touching an intra-day peak of US\$1911/oz on the 23rd of August. Whilst volatile, the gold price is performing its traditional role as an investment safe haven in these uncertain economic times.

Negative Influences

| Company | August Return % | Fund Position % |
|----------------------|-----------------|-----------------|
| Southern Cross Media | -12.3 | 2.4 |
| Emeco Holdings Ltd | -14.0 | 2.1 |
| ANZ | -3.3 | 8.6 |

- Southern Cross Media reported a slightly stronger than expected result due to higher levels of synergies, however the market downgraded FY12 revenue growth assumptions reflecting the weaker macro environment. The company's guidance on the debt profile was of critical importance was with net debt-to-EBITDA to fall below the critical 3x level this quarter post debt refinancing, and interest cover currently over 4x. Further cost savings are expected with the company leveraged to any improvement in the economy.
- Emeco fell over the month despite reporting a FY11 result in line with forecasts and at the mid point of company guidance. Average utilisation during FY11 was running at 85% whilst the company has entered FY12 with an utilisation rate of 83% and expects this to increase with improvements in the Indonesian and Canadian oil sands markets. The company did not provide FY12 guidance but noted the outlook was positive.
- ANZ underperformed major peers in August. The bank released its 3Q earnings, with pre-provision operating profit disappointing on the back of weak income from the bank's Global Markets division, specifically from poor trading income. Management noted the decline experienced in trading had continued in 4Q11.

Outlook

Looking at historical measures the Australian market remains excellent value based on fundamentals, with the S&P/ASX200 trading on a 2011 PE of 11.8x and a forecast 2012 PE of only 10.6x at August end. These multiples, with the exception of the period surrounding the GFC, are at two decade lows.

The market has exited reporting season with a 13% FY12 EPS growth forecast (IBES) yet concerns remain regarding the forward earnings trajectory. Earnings revisions to FY12 were generally negative, with 57% of companies receiving a downgrade and just 11% an upgrade. If given, outlook statements were generally uncertain or negative. Lodestar remains cautious as to the outlook for the domestic economy with the only sectors producing earnings upgrades being the defensive Utilities and Telecoms.

Consumer and business sentiment is low as deteriorating domestic economic data and disillusionment with the Government is driving savings rates higher and private sector credit growth lower. Building approvals remain in a clear down trend. The high Australian dollar is causing a fall in tourism domestically as Australians increasingly travel offshore. The currency, and attractive internet shopping alternatives, is also driving further retail spending abroad.

Poor economic data and a lack of strong leadership is affecting consumer sentiment across both North America and Europe. During August the USA saw the Thompson Reuters/University of Michigan Consumer Sentiment Index drop to its lowest reading since May 1980. Further a horrible August Philadelphia Fed Manufacturing Index number was reported with the components of new orders, shipments and employment all universally weak. Initial claims numbers remain stubbornly poor but a better ISM print in early September and anticipated better employment numbers as the northern hemisphere returns from holidays may signal that the US has avoided returning to recession.

Meanwhile European PMI's are deteriorating and retail sales remain weak across the region. Crucially German growth has slowed to anaemic levels. The continuing Euro zone debt conundrum hangs over the regions consciousness with increasing concern that authorities are unable to implement a sustainable form of region wide fiscal discipline and resolution to the malaise.

Internationally there uncertainty as to the way forward following an increasing recognition that traditional monetary and fiscal policy measures are largely spent, particularly in the USA.

Domestically the RBA has removed the tightening bias as they continued to leave interest rates on hold at 4.75%. The market has priced 100bp of rate cuts by December 2011 based on the deteriorating domestic economy as the RBA comes to terms with an increasingly two speed economy.

With the market at historically cheap levels certain areas of the market appear particularly attractive. Hard commodity prices are through their period of seasonal weakness but still face increasing cost pressures, whilst soft commodity prices are being bolstered by northern hemisphere drought cutting production levels. Domestically political change or an interest rate cut could act as a circuit breaker for the market. In addition, large caps such as banks and Telstra are yielding significantly higher than term deposits and three year government bond yields versus historic differentials.

Looking at what will drive the market, there is still an expectation that the US may well announce the long anticipated QE3 stimulation package as their economy continues to disappoint. Whilst the market is focused on any comments by Bernanke on the likelihood of this, all eyes will also be on President Obama who is due to deliver his speech in September on job creation. This may prove to be a critical address as the political stakes for re-election have become very high.

In Europe the market will continue to focus on sovereign debt issues. The ECB appears committed to shoring up the Spanish and Italian bond markets, but the Greek situation is clearly deteriorating with the EU/IMF/ECB to conduct a technical review of Greece. Greece's latest budget numbers show YTD revenue down 6.4% whilst spending up 7.3%, which is clearly unsustainable. Assets sales are slow and tax collection lagging in such a weak economy.

In China there is an expectation that we have seen the end of the tightening cycle. The Chinese Purchasing Managers Index is also showing tentative signs of levelling out and creating a solid base.

In Australia the reporting season was generally in line with expectations. The forecasts for financial year 2012 are being downgraded though this is generally expected by most investors. The market is historically very inexpensive however a positive catalyst is needed to spark a rally of substance. This could come in the form of a cessation of downgrades to future earnings, a cut to official interest rates, political change at a Federal level, or a positive outcome to the northern hemispheres economic reform initiatives.

We will continue to look for opportunities to purchase selective stocks that represent exceptional value for the medium term.

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