

# Lodestar Australian Strategic Share Fund

## Monthly Investment Report

January 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 Australian sharemarket rose slightly, up 0.2% in the month of January, lagging most developed markets with the S&P500 up 2.3% and Euro Stoxx up 5.8% in local currency terms. The U.S. was buoyed by a strong reporting season and continuing strong economic data. Europe was particularly strong following stabilisation in the bond markets of the smaller Eurozone member States such as Portugal and Greece.
- Financials outperformed Resources, a reversal of last year's trend. The Resources index was down 3.1% whilst Banks performance was almost the mirror image with a 2.9% rally. The market was preoccupied with the risk of further policy tightening from the Chinese administration with the December CPI reading remaining high. The impact of the Queensland floods was also a concern for many stocks, including the insurance industry.
- Towards the end of the month global sharemarkets pulled back following unrest in Algeria and Egypt which sparked concerns of regime change in these countries and potential spread of further unrest in Africa and the Middle East. Domestically a number of companies issued adverse commentary in relation to the effects of the severe flooding in Queensland.

### Fund Performance

Period ending 31.01.11	1m %	3m %	1yr %	2yr % p.a.	3yr % p.a.	Since Inception % p.a.
Total Return	-0.04	0.40	-1.10	10.38	-1.81	-0.02
90 Day Bank Bill*	0.42	1.24	4.77	4.11	5.21	5.59
S&P/ASX 200 Accum <sup>^</sup>	0.18	2.74	8.46	21.07	-1.26	-0.89

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.

<sup>^</sup> 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.

Inception date 1 March 2007.

- We acknowledge that since the market began to stabilise in the third quarter and move ahead from that point, investors may have expected our portfolio to capture the market rally. Our low exposure levels held throughout the second half of 2010 were due to our belief that significant risk remained within the market until late 2010. Consequently we have increased exposure over the last two months as we have seen the risk levels decrease. Such action is consistent with our process and desire to avoid unrewarded risk for investors.

- In January the Fund continued to increase its exposure to the market with the net exposure rising from 41% to 48%. There was little movement in the physical long exposure, though there was a slight reduction of the Resource exposure in favour of Banks. The increase in the net exposure was achieved by reducing the amount of short positions in the portfolio and introducing an Index call option position.
- The shorts that were reduced were stocks that fell to levels that Lodestar were happy to buy back. Certain shorts were retained as we anticipate commentary and results will disappoint in the forthcoming reporting season as profits are pressured by the combined high currency and the affect of the RBA increasing official interest rates. The Index call option position was a good risk adjusted method of increasing exposure to the market.

## Positive Influences

Company	January Return %	Fund Position %
Wotif.com Holdings	-16.1%	-0.7%
Caltex Holdings	-6.7%	-0.9%
James Hardie Industries	-8.3%	-0.5%

- Wotif Holdings' share price fell on the fears that the amount of holiday travel would be curtailed over the peak seasonal period following the recent extreme weather conditions over the summer holidays highlighted by the flooding of Queensland. This is with the backdrop of a fragile environment for discretionary consumer spending reflected by a number of profit warnings from retailers prior to Christmas.
- Caltex has been trading at historically high valuation multiples. The announcement in January that the heavy rains in Queensland had caused an outage in its Lynton refinery weighed on the stock, with the cost to return the refinery to normal operations in the order of \$5m to \$10m of profit.
- After performing well in December James Hardie Industries' share price pulled back as U.S. housing data continued to reflect a poor recovery in the housing cycle.

## Negative Influences

Company	January Return %	Fund Position %
Panoramic Resources	-9.4%	1.6%
Newcrest Mining	-8.9%	1.4%
ResMed Inc	-8.7%	1.4%

- Panoramic Resources' share price fell after recent gains, which is coincident with most global cyclicals. The main catalyst was the concerns that Chinese authorities would continue to target their higher inflation with further monetary policy tightenings, which in turn could soften the pace of economic growth.
- Newcrest Mining share price movements are usually correlated with the Gold price. Over the month the Gold price fell from US\$1421.4 to US\$1334.5, a fall of over 6%, placing the Newcrest share price under pressure. There has been stabilisation recently with the protests in Tunisia and Egypt bringing some support back for Gold.
- There were developing concerns that ResMed Inc may have a soft December quarter earnings announcement, however they actually announced record revenues and income for the quarter. The stock price began to recover then the CEO Kieran Gallahue unexpectedly resigned in early February only a week after the financial results. As a result the stock price has not deviated significantly since the time of the result.

## Outlook

- The latest concern to hit the markets has been the unrest that started in Tunisia and spread quickly to Egypt, increasing the regional geopolitical uncertainty. This has seen a slight rally in the price of Gold, however the price is still lower than prices seen in November and December. There has been no sign of any disruption to traffic through the Suez Canal and OPEC has spare capacity to offset Egyptian oil exports. The key risk is if the unrest and anti-government protests spread to other Middle Eastern countries such as Saudi Arabia.
- Meanwhile the U.S. economy continues to improve with most segments of the economy expanding strongly since October. Production, income, consumption, sales, new orders, inventories and even employment measures have improved in recent months. The ISM surveys, manufacturing and non-manufacturing, have hit six and a half and five year highs respectively. The dips in these indicators mid-year have clearly reversed. The official employment data continues to expand but not at the pace financial markets are expecting. The official unemployment rate has now fallen from 9.8% to 9.0% in two months, assisted by a fall in the participation rate as some people give up looking for work. The only significant component of the U.S. economy that is not showing a proper turnaround is the construction and property market. Lodestar is of the opinion that the U.S. economy is pivotal globally at the moment, and the previous indicators are particularly good news with the accommodative stance of Bernanke's Fed Reserve being reinforced in recent releases to the market.
- The U.S. reporting season for the December 2010 quarter is coming to an end with 71% of companies exceeding market expectations at the time of writing. The key to this data is what happens to earnings expectations for calendar year 2011, which have fallen from 23% to 13%. The key with this metric is that there seems to be some stabilisation to this expected growth rate now the December data is in. The U.S. sharemarket has been preoccupied with the level of revenue growth as opposed to the net income line, which is because the first uplift in the earnings cycle was all about cost cutting. This has a finite cycle to it and to get a more sustainable profit cycle the revenue line needed to improve. The revenue growth for this quarter was the best this year at 5.5% (qoq) with negative growth seen in the first half. The view is now that the profit cycle and the general economy have finally shifted towards sustainable expansion as opposed to below par fragile recovery.
- The Eurozone sovereign debt issue has seen some stabilisation in recent weeks and the key bond auctions by Portugal and Spain are being received well. The absolute level of bond yields is still uncomfortably high, particularly in Portugal with yields at 7.0%.
- China has become increasingly aggressive in its policy tightening since inflation rose to 5.1% in November. Outside official interest rate hikes there have been four increases in its reserve requirements in just two months. New loan creation totalled RMB 7.95trn in 2010, overshooting the official target of RMB 7.5trn. In addition lending in January was strong again, with China's policy makers seemingly using reserve requirements as a primary tool to limit credit growth. GDP growth has remained robust at 9.8%, better than expected. Commodity prices, which make up a third of Chinese CPI, have continued to rise internationally.
- Last month's commentary touched on the two speed economy in Australia. The December half reporting season is now upon us and the extent of this phenomenon will have some light shone upon it. The floods in Queensland and Victoria and now the cyclone in far north Queensland has added further complexity to this and many companies have already issued statements on the likely affect - though many have yet to quantify the impact.
- Retails sales, employment, credit growth and even consumer and business confidence have lost momentum recently. The positive side to this fall in momentum in some segments of the economy is that the RBA seems to have taken a gentler stance towards the tightening cycle. The Bank Bill rate fell 25 basis points to 5.24% in January.
- At the time of writing there has already been mixed results; with JB Hi Fi coming in line with expectations of double digit profit growth and Myer indicating that profits will be down as opposed to market expectations of a rise in full year profits. We remain of the view that there is likely to be quite divergent results across the market spectrum.

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