LODESTAR
Capital Partners

Lodestar Australian Strategic Share Fund
Monthly Investment Report

July 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 3.97% in July, the fourth consecutive monthly fall and the longest losing streak since February 2009. The Index underperformed the UK, US and Asian markets whilst outperforming a dismal euro bloc where the Euro Stoxx 50 fell 6.1% over the period in local terms. Fiscal strains in both the eurozone and in the United States were the major causes of the fall but negative local data also contributed, raising concerns on the local earnings outlook with a strong CPI number dampening hopes of a reversal of the Reserve Bank's monetary stance.
- Local economic data continued its recent negative trend with weak business and consumer surveys coupled with soft retail numbers pointing to poorer levels of activity. Whilst the CPI print dashed any hopes of a rate cut in the near term, the yield curve is indicating that domestic rates will move lower into 2012. David Jones, when announcing downgrades to guidance for both 2H11 and 1H12, best summarised the current economic conditions by citing a "dramatic and rapid deterioration in trading conditions in 4Q11".
- Meanwhile in Europe, whilst EU leaders agreed to a new debt relief package for Greece, as well as easier funding terms for other struggling euro nations, markets remained nervous that the package did not go far enough to stabilise the region's fiscal problems. The eurozone composite PMI fell in July to 50.7 from the 53.3 in June and well below the consensus of 52.6 as higher oil prices, the global slowdown and budget cuts all weighed on growth. The region's preliminary growth rate for the quarter was only 0.2% after an increase of 0.8% in the prior period.
- In the United States markets remained extremely concerned as short term political posturing seemed to outweigh the implications of a potential default by the US Government with Congress failing to raise the US Treasury's borrowing capacity, a limit set to be exceeded in early August. However corporate news was more supportive with the 2Q earnings season pointing to the resilience of corporate profits as 75% of the 302 S&P 500 companies that had reported by month end beating expectations.
- China, having raised reserve requirements six times earlier this year, is clearly now slowing with the latest PMI producing its lowest number in 28 months down to 50.7, further confirming a cooling of the red hot Chinese economy. However a resilient consumer and continued investment in infrastructure still supports GDP growing at near 9% over the rest of the year. Despite this there continues to be an expectation that the next move may be a policy loosening as hinted by Chinese Premier Wen Jiabao in June.
- Over the month the Australian Government announced the details of its proposed carbon scheme with a price of $23/tonne of CO_2 scheduled to commence on the first of July 2012 which affected sentiment. News Corporation was embroiled in investigations into phone hacking in its UK newspapers raising serious corporate governance issues and BHP announced a $14.3 billion takeover offer for US shale gas company Petrohawk Energy.

Fund Performance

Period ending 31.07.11	1m %	3m %	1yr %	2yr % p.a.	3yr % p.a	Since Inception % p.a.
Total Return	-2.46	-5.30	-2.71	2.90	-2.93	-0.87
90 Day Bank Bill*	0.42	1.24	5.02	4.51	4.73	5.53
S&P/ASX 200 Accum^	-3.97	-7.56	2.70	6.36	0.52	-1.95

Standard Deviation#	
Fund	13.03%
S&P/ASX 200 Accum	16.88%

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.

- For the month of July the Fund produced a return of -2.46% outperforming the S&P/ASX 200 Accumulation Index which fell 3.97%.
- Over the month the net market exposure was reduced from 94.4% to 77.7% in response to a deteriorating economic outlook in both Europe and the United States.
- Metals and Mining exposure was increased by 4.9% whilst Energy was reduced 1.5%.
- Media was decreased 1.8% as the fund exited News Corporation on corporate governance concerns.
- Exposure to Food and Staple retailing was increased 0.5% via lifting exposure to Wesfarmers.
- Banking exposure was reduced by 7.9% to 21.9% of the portfolio.

Positive Influences

Company	July Return %	Fund Position %
Macarthur Coal	42.0	0.8
Eastern Star Gas	41.3	0.4
PanAust Limited	8.8	2.5

- Eastern Star: In mid July, Santos announced it intended to acquire 100% of Eastern Star Gas via a Scheme of Arrangement, offering 0.06803 Santos shares for each Eastern Star Gas share held. At the time of the offer, this represented a 51% premium to the Eastern Star Gas share price and the Eastern Star Gas directors voted unanimously in favour of the deal. The Fund sold its position in the market rather than accepting Santos scrip.
- Macarthur Coal announced that they had received an indicative proposal from Peabody Energy and ArcelorMittal to make an off-market takeover bid to acquire a controlling interest for $15.50 per share, less the amount of the final dividend. The share price prior to the bid was $11.08. On the 14 of July Macarthur Coal announced they had agreed to allow due diligence to proceed on condition the bid price was increased by the 16cps final dividend. The Fund sold its position in the market rather than wait for completion of the offer.
- PanAust Limited rose strongly during the month on the back of a rallying copper price. The company also had the advantage that it is not leveraged to a rising $A/$US exchange rate.

Negative Influences

Company	July Return %	Fund Position %
National Australia Bank	-6.3	6.6
ANZ	-5.3	7.6
CBA	-5.8	6.0

- Banks underperformed over the month as the market focused on eurozone sovereign debt issues and the US governments' impasse in attempting to raise its debt ceiling. Domestically the low levels of private sector credit growth fell to multi decade lows, with investors reducing their exposure using the banking sector as a proxy. Surprisingly Australian banks have fallen this year almost exactly the same amount as banks globally despite the lower unemployment locally, high sustainable dividend yields and their reduction on reliance on wholesale funding. Except during the GFC, the gap between the government bond rate and the major banks dividend yields has never been greater. On yield alone Australian banks are very attractive.

Outlook

The Australian share market remains fundamentally excellent value on historical measures, trading on a price earnings ratio of only 12.1x for the financial year ending 2011 and 10.5x for 2012, however in Lodestars opinion the earnings growth implicit in the 2012 multiple of 16.3% will be likely too high. With the exception of the GFC, these are the lowest levels seen by the market in two decades.

Whilst the European Financial Stability Facility (EFSF) has boosted flexibility via varying maturities and rates it has not altered the size of the facility. Short term this hasn't appeased the bond market with Spanish and Italian bond rates moving above 6% and raising concerns as to the stability of the two. The market is still concerned about the direction of European interest rates, particularly regarding the PIIGS, even after these measures. Overlying this meanwhile European PMI's continued to trend down over the summer.

In the USA a compromise was reached at the eleventh hour on increasing the debt ceiling and averting the United States tumbling into default, but the agreement to aggressively cut US debt obtained by the Republicans in return for their support saw the market immediately focus on the inability of the government to use fiscal stimulus moving forward. This concern was heightened by continuing evidence of a slowing economy particularly the rapid decline of the manufacturing ISM which fell to 50.9 in the July reading from 55.3 in the previous month. The market is now hoping that the Federal Reserve will commence another round of quantitative easing to try and maintain some momentum in the faltering recovery.

However it is important to note that despite the dismal macro outlook the US reporting season has thus far been strong with US corporate earnings to date exceeding expectations. The S&P500 so far has produced earnings growth of 15% versus initial expectations of only 13%. This however has not been translated as yet into private sector job growth which leads to the current concerns on consumer consumption and confidence, factors which dominate US economic growth. Further, the political imperative for jobs growth is now heightened due to the fact that we are now only 15 months from the next US Presidential election. In the run up to this, employment growth and ISM will be all important.

Meanwhile China continues to walk the tightrope of sustaining high growth rates whilst controlling inflationary pressures. With the Chinese economy now slowing we anticipate an end of the tightening cycle by year end and that there may be some easing as we move into the New Year if the slowing is confirmed.

In Australia we are in the early stages of the reporting season which to date has produced mixed results but downbeat forward commentary. This confirms our expectation that whilst earnings will generally be at or around consensus the outlook statements will be cautious. Whilst we expect some profit warnings, the portfolio is constructed conservatively with the portfolio trading at a valuation discount to the market highlighting the component stocks' good value.

A key issue moving forward is whether the current cheap market valuations have pre-empted this.

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