

Lodestar Australian Strategic Share Fund

Monthly Investment Report

May 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 ASX200 fell 2.0% over the month of May to its lowest level since June 2010 as the market focused on a weaker economic outlook both domestically and abroad and on increasing concerns regarding the domestic markets forward earnings estimates.
- Whilst capex intentions of Australian companies remain firm according to the first-quarter ABS survey, weaker than expected jobs numbers and mortgage data raised concerns that activity outside the Mining sector may be slowing. The Federal Treasurers Budget Statement showed a deficit slightly larger than expected but reiterated the aim to return to surplus in two years time.
- Housing credit is at the lowest yearly growth rate since the Reserve Bank of Australia began collecting data in the late 1970's, and the savings ratio is now at the highest level since 1986.
- Overseas markets were weak over the month with the S&P500 off 1.4%, the Euro Stoxx 50 down 5% and the MSCI Asia ex Japan off 1.7% in local terms. Markets focused on weaker economic data emanating from the US, evidence of a cooling in China, albeit to growth levels still the envy of the world, and continuing problems in eurozone sovereign debt markets as the focus returned to the unsustainable debt positions of certain members.
- US data was mixed with payroll news positive but signs of slowing momentum in manufacturing and retail sales. The People's Bank of China announced a rise in bank reserve requirements of 50 basis points, its eighth such move in seven months, whilst in Europe the eurozone sovereign debt crisis continued pressuring markets with Portugal securing an EU/IMF bailout with Greece's woes remained unresolved.
- With the end of the financial year approaching a number of companies updated the market on earnings prospects with the majority of these lowering expectations (APN, Fairfax, Bluescope, One Steel and David Jones) whilst the banks reported earnings in line with expectations.

Fund Performance

Period ending 31.05.11	1m %	3m %	1yr %	2yr % p.a.	3yr % p.a.	Since Inception % p.a.
Total Return	-1.93	-1.25	-0.18	8.54	-3.53	-0.09
90 Day Bank Bill*	0.42	1.24	4.96	4.36	4.90	5.55
S&P/ASX 200 Accum [^]	-1.97	-1.60	10.84	15.71	-1.64	-0.66

Standard Deviation [#]		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.
Fund	13.29%	* 90 day Bank Bill rate resets quarterly and is used for the purposes of calculating the performance fee.
S&P/ASX 200 Accum	17.45%	[^] 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 negative return of 1.9% and increased its exposure from 91% to 96% over the period.
- The Fund further reduced its exposure to both the Metals and Mining industries on further expected weakness in commodities prices.
- The weighting to the Banking sector was increased over the period mainly later in the month.
- The holding in Telstra was added to over the month.

Positive Influences

Company	May Return %	Fund Position %
Telstra	3.7	4.6
Graincorp	5.4	2.3
Wotif.com	-11.0	-0.9

- TLS performed strongly during May owing to positive momentum surrounding the NBN, with the market expecting an announcement from the Government shortly. The completion of their 4G network and Foxtel's acquisition of Austar were also positive for sentiment.
- Graincorp rallied sharply following a profit announcement higher than market expectations and on a positive outlook for wheat prices and this winter's growing season. Commentary on the malt division was more positive as oversupply concerns eased in the face of downgrades to estimates for northern hemisphere production of barley. Guidance was significantly increased.
- Wotif fell heavily with other discretionary skewed peers on ongoing consumer softness and sentiment issues.

Negative Influences

Company	May Return %	Fund Position %
ANZ	-6.2	8.4
CBA	-5.9	6.3
WBC	-8.2	2.7

- The Banking sector underperformed as Moodys downgraded the majors' long-term credit ratings a notch due to a change in the ratings agency's methodology, which highlighted the sectors reliance on offshore funding. March housing approvals for owner-occupiers reached their lowest level in 10 years. The first half 2011 bank results showed a sector wide trend of increasing mortgage arrears, though much of this was attributed to flood ravaged Queensland. In addition, as mentioned earlier the private sector credit growth numbers showed the lowest annual mortgage credit growth rate seen since numbers were collected in the 1970's, and the recent improvement in personal and business credit momentum waned in the monthly data release. Valuations on banking stocks have become historically very inexpensive, with the recent moves down now have historic dividend yields of 6.5% to 7.0% fully franked. Market consensus expectations are for dividend growth above this for the next year, and thus yield alone should begin to protect this sector from further significant downside.

Outlook

Recent weaker than expected US data has negated the previous months more buoyant tone which followed the upbeat US reporting season and improved employment data. In addition there is a little disquiet on how the U.S. financial assets will perform without further monetary stimulus in the form of QEIII. Consequently Lodestar's base case of a continuing strengthening US economy in the medium term has been tempered on a short term basis. In a nutshell we have become more cautious as to global economic momentum.

Chinese authorities clearly are continuing to slow their economy, and in particular target inflation, as evidenced by the eighth rate rise in seven months. In addition there are signs that the momentum in the Chinese economy is waning, such as the recent Chinese Purchasing Managers Index falling to 52. However it was anticipated to be lower than the eventual reading and thus there is an impression that the slowing in growth is being well managed and not out of authorities' control. Food inflation remains an issue with the price of pork, a commodity that is 7% of the official CPI, rising significantly in May. It will be difficult to see industrial commodities prices rising with China's importance to these markets, and to date these prices have been quite resilient.

Locally the higher \$A and increasing operating costs are leading to pressure on resource stocks. Whilst in the shorter term Lodestar has become more cautious on commodity prices, in the medium to longer term the outlook remains quite positive. If current commodity prices are maintained and cost can be managed, valuations are attractive at this time.

Whilst still remaining concerned as to the scale of the European sovereign debt issue we are increasingly of the view that European authorities are now veering towards allowing the Continents debt problems, particularly in Greece, to be rescheduled rather than brought to a head. Thus a muddled outlook appears to be the most likely in the short to medium term. The latest iteration is that there may be a rolling of debt maturities in the "troubled" sovereign states to avoid a default trigger that would bring on writedowns to private sector bondholders.

The Banking sector was the worst performing sector last month. This can be explained by poor private sector credit growth figures, the fear of further RBA hikes in official interest rates, the potential stress on international wholesale funding costs (courtesy of the fear of a Greek default) and the fear of residential property prices falling. All of these are real risks, however most of these issues are fears at this stage. Firstly, the very subdued private sector credit growth is not a new phenomenon. The recent banks results have proved to be reasonably resilient in the environment of the "new austerity" in leverage. The fear of higher interest rates is ensuring that the savings rate remains at multi year highs. The RBA has now been on "hold" since November and the consumer reaction to the November tightening has echoes of 1994/1995 about it. In this instance the RBA remained on "hold" for a considerable time with the inflation fears receding during this period. The authorities in Europe seem to be attempting to at least postpone any defaults in Greece, Portugal and Ireland, and if they are successful then a sudden rise in international funding costs will not eventuate. Under most measures the residential housing market is expensive, however to get a significant fall in prices and increased defaults there needs to be increase in unemployment if history is any guide. This seems unlikely at this stage of the economic cycle. Market consensus expectations for banks' earnings growth have been wound down over the past nine months to levels we think are now achievable, although there may be some continued downgrades but they are likely to be incremental. Valuations and dividend yields are at very attractive levels historically, for example most major banks are now trading at 6.5% to 7% fully franked spot yields versus a one year term deposit of now under 6.0% (unfranked). Importantly we are of the view that these dividends are safe.

With such an outlook the Australian market will likely remain in a trading range. The market is now focusing more on 2011/12 earnings estimates which in our opinion remain too optimistic for domestic industrial cyclicals compared to the local economy's reality. However, the upcoming reporting season in August will shed light on how much revision downwards is required. In this environment valuation on most companies are undemanding at the low end of the trading range that has now been in place for eighteen months. We are likely to vary our net exposure in reference to this trading range.

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