Aegis Growth Model Portfolio - Monthly Report

Market Review – June 2010

After recovering somewhat in early June from the market declines witnessed in May, global equity markets resumed their downward path in late June, driven by lingering concerns over the health of several European countries and some softening economic data from the United States.

While we expect positive global economic growth to continue this year and next, not subscribing to the double dip scenario that some market economists and strategists are espousing presently, the rate of growth may nevertheless be more muted than earlier consensus forecasts have suggested.

After declining 7.5% in May, the S&P/ASX 200 Accumulation Index declined a further 2.6% in June. For the calendar year to date to end June, the market is down 9.9%. While the monthly decline was significant, the local bourse fared better than many other developed world indices with the US Dow Jones index down 3.6%, the US S&P 500 index down 5.2% and the US Nasdaq index down 6.6%, displaying the relative flight to large cap stocks during periods of market nervousness. Elsewhere, Japan's NIKKEI index declined 4.0%, UK's FTSE index fell 5.2%, France's CAC-40 index was off 1.8% and Germany's DAX index performed well at a flat 0.0%.

As for May, sector performances varied widely, with better performances, relatively speaking seen once again in the defensive sectors of Consumer Staples (0.7%) and Health Care (0.5%). They were joined by Telecommunications (9.5%) and Utilities (2.0%) reversing their weak performances in May.

Other sectors to "outperform" the overall market included Materials (-1.1%) and Information Technology (-1.1%). Underperforming sectors were Energy (-2.6%), Consumer Discretionary (-5.3%), Financials (-4.7%) and Industrials (-7.3%).

A review of the first half of the calendar year reveals a clear divergence between the performance of cyclical and defensive sectors. Where cyclical sectors rallied strongly from the lows of March 2009 to year end 2009, the reverse has been true over the last six months as economic reality takes time to catch up with the enthusiasm shown by investors for growth stocks last year. Consequently, the cyclical sectors have experienced a degree of reversal to date this year.

Compared to the S&P/ASX 200 Accumulation Index decline of 9.9% over the first half of the year, defensive sectors such as Telecommunications (-2.4%), Utilities (-3.0%), Consumer Staples (-3.5%), Information Technology (-4.6%) and Health Care (-6.1%) have performed relatively well in this environment. Even the Materials sector, buoyed by ongoing strong economic growth in China, outperformed the market slightly at -9.7%.

These performances contrast against cyclical sectors such as Consumer Discretionary (-10.0%), Energy (-11.6%) and Industrials (-19.2%). In addition, the Financials sector impacted by negative sentiment from abroad over the health of the European financial system has declined 10.9% this year to date.

Aegis Market Outlook

The US economy is showing signs of moderating in its rate of growth in recent months. The US service sector activity grew more slowly in June as business leaders fretted about the labour market's perilous state. The ISM's overall index of non-manufacturing activity eased to 53.8 from 55.4 in May, falling short of the 54.9 reading economists were expecting. The Conference Board said its June employment trends index is up 0.6% at 96.7 from May's revised 96.1, first reported as 95.7. The moderate increase in labour data suggests companies remain unsure of the recovery. Payrolls data for June showed a headline fall of 125,000 as temporary hiring of census staff begins to be unwound. Census jobs declined by 225,000 with the private sector adding a modest 83,000 jobs in the month, following a 33,000 gain in May. While positive, monthly job creation has to be in the 200,000 range to make inroads into the high unemployment rate.

Reflecting this trend, US bond yields continued to decline in June, while bill yields remained largely unchanged at very low levels. Ten-year bond yields declined by 34bps to 2.97% while 5-year bonds were 31bps lower at 1.79%. Short-term paper saw yields essentially unchanged with 90-day bills at 0.18%, up 2bps over the month and 180-day paper unchanged at 0.22%. The spread on five-year treasury notes over 10 years was slightly narrower by 3bps to 118bps while that of 180-day bills narrowed to 275bps, causing the yield curve to flatten further. The US bond yields suggest either inflation is not expected to be a problem in the immediate term and / or economic growth is not expected to be overly strong.

Locally, the RBA continued to hold interest rates steady at 4.50% at its regular meeting in early July. The RBA stated that while the global economy continues to grow, expansion remains uneven with Asian and Latin American growth strong while advanced economies are showing modest growth. Chinese growth is starting to moderate to a more “sustainable” rate, good news for a market fearful of this economy over-heating or facing an asset bubble. The outlook for Europe remains uncertain with Germany performing relatively well, while the PIIGS nations continue to face financial challenges. While US growth has been reasonably strong in the first half of the year, thanks largely to a re-stocking phase, indicators are suggesting a slowing of activity in the second half with payrolls data remaining weak, combined with housing starts falling.

Domestically, the RBA’s expects our terms of trade to grow substantially, leading to output growth expected to be above trend. Importantly, business investment is expected to rise over the next year to take over from government stimulus measures which are winding down. The ABS reported Australia posted its biggest monthly trade surplus since March 2009 in May, confirming a massive turnaround in the trade account on the back of surging coal and iron ore prices. The seasonally adjusted balance on trade in goods and services widened to a surplus of $1.65bn in May from a surplus of $1.12bn in April. Imports rose 4% in May with exports surging 6%. The ABS also revised higher its April trade surplus to $1.12b, up by almost $1bn from its original estimate.

We continue to take a cautiously optimistic view of the Australian equity market, with a patient, “buy the dips” approach to investing suggested in the short term.

Growth Portfolio Model in Review

The portfolio outperformed the benchmark over the month. Among the outperformers were Telstra, Woolworths and BHP Billiton. The main underperformers were Toll Holdings, Leighton Holdings and WorleyParsons.

Four portfolio stocks outperformed the benchmark and six underperformed. Woodside Petroleum performed in line with the benchmark index. In absolute terms, only two stocks increased in value over the month.

It is important to maintain a medium-term perspective with a well-diversified portfolio structure. We maintain preferential exposure to large-cap sector leaders in preferred sectors, capable of withstanding current challenging market and economic conditions, via stock selection.

Contributors to Outperformance and Underperformance

Growth Portfolio - Contributors to Outperformance

Telstra Corp - TLS (+10.5%)

On 21 June TLS announced it had signed a non-binding heads of agreement with NBN Co which will see it receive $11B in value for migrating voice and data traffic to NBN, allowing NBN to use its infrastructure and the value of avoiding USO costs. On first impressions, we view the agreement positively as it removes some of the uncertainty surrounding TLS and provides compensation for the gradual wind-down of its old cooper network. Full details are yet to be agreed and the deal won't be put to shareholders until 2011.

Woolworths - WOW (+1.4%)

WOW's market leading position in supermarkets, petrol and liquor is expected to underpin near-term earnings growth. This is supported by company guidance of FY10 NPAT growth of 8% to 11%. WOW's strong like-for-like sales growth, margin appreciation, superior logistics and scale present a compelling investment case. The company is very well managed, has a very robust balance sheet and strong competitive position. WOW's EPS growth is strong and the company has very little debt.

BHP Billiton - BHP (-1.5%)

On 21 June, BHP announced it had signed a non-binding Heads of Agreement with the Government of Western Australia to amend the Iron Ore royalty rates payable to the State, effective 1 July. According to the company the changes will enable BHP's existing iron ore operations to operate more efficiently. The company said it will also facilitate the proposed West Australian Iron Ore Production JV between BHP and RIO which is still subject to regulatory and shareholder approval.

Growth Portfolio - Contributors to Underperformance

Toll Holdings - TOL (-11.9%)

TOL downgraded its earnings guidance for 2H to around 5-10% above pcp, below the guidance given at the interim result. The company blamed deteriorating market conditions. In the same announcement, the company announced it will buy DPEX Group from Qantas. DPEX is one of the largest independent express businesses in Asia. DPEX will complement the growth of Toll Priority international express network in the Asia Pacific region. The acquisition will add over $30m of revenue and should be EPS accretive in year one.

Leighton Holdings - LEI (-11.3%)

LEI announced the following contact wins in June: $273m, 6-year, contract to develop and operate the Mongolia Energy's Khushuut coal mine in western Mongolia (Leighton Asia); $170m, 3-year contract extension from Consolidated Minerals for the Woodie Woodie managanese operations (HWE Mining, part of Leighton Resources Division); $1.6bn, 6-year contract extension for mining services at the MSJ coal mine in East Kalimantan in Indonesia (Leighton Asia). LEI also announced the 9.7km M80 Ring Road Upgrade contract has been finalised at $623m. LEI CEO Wal King has reiterated guidance for FY10 net profit in excess of $600m (we forecast $629m).

WorleyParsons Ltd - WOR (-10.0%)

WOR reported Vale has awarded a significant cost reimbursable contract to a consortium of the Company and SNC-Lavalin for implementation of the S11D project in Brazil. Vale's S11D project is a 90Mtpa iron ore processing facility located approx. 1,940km north east of Sao Paulo in Para State, Brazil. The Company's services include engineering, procurement support, construction management and supply of key project management professionals and leadership to the project owner's team.

Growth Portfolio Changes for the month

On 8th June:

- Increased weighting in WBC by 3%.
- Decreased weighting in Cash (to fund above transaction).

Corporate Actions

Nothing to report.

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