

Aegis Emerging 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 \$1.12bn, 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.

Emerging Portfolio Model in Review

The portfolio outperformed the benchmark over the month. Metcash, APA Group and Ansell were the main contributors to outperformance. AWE again led underperformance for the month. Seek and Healthscope also underperformed.

Eight portfolio stocks outperformed the benchmark and four underperformed. In absolute returns, seven recorded positive returns, while five declined 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

Emerging Portfolio - Contributors to Outperformance

Metcash - MTS (+12.7%)

Metcash said wholesale sales rose by 4.9% to \$11.5Bn, EBITA grew 8.6% to \$415.4M, operating cash flow rose 18.8% to \$294.7M, profit after tax, pre non-recurring item, rose 8.5% to \$238.4M, underlying earnings per share grew 8.4% to 32.0cps, and dividends for the period increased 8.3% to 26 cents fully franked. Reported profit after tax grew 12.4 per cent from \$202.5M to \$227.6M. Wholesale sales rose 4.9 per cent from \$10.97Bn to \$11.51Bn.

APA Group - APA (+8.3%)

APA's ability to overcome short-term capital constraints through equity raisings, refinancing and asset sales demonstrates the quality of its assets. Although look-through gearing has been reduced, it is still high and APA still operates with low interest cover. However, revenue is regulated or contracted, enhancing long-term cash flow certainty. APA pays an attractive distribution funded from free cash flow. During June APA announced its estimated distribution for the six months ended 30th June of 17.0 cents per stapled security.

Ansell - ANN (+5.0%)

ANN is a top three global player in each major business. It has progressively restructured to deal with high latex and oil prices, improved manufacturing efficiency, rolled out innovative higher-margin products, expanded into new markets and dropped unprofitable business. ANN has come through the GFC in good shape and will benefit as the world economy rebounds. ANN has conservative gearing and strong interest cover.

Emerging Portfolio - Contributors to Underperformance

AWE Limited - AWE (-14.3%)

On 25th June AWE announced that its wholly owned subsidiary, ARC Energy had achieved 51.2% ownership of Adelphi Energy. A few days earlier ARC had increased its offer to \$0.42 cents per share (from \$0.40 previously). In operational news, AWE advised that the Tui SW-2 exploration well has been suspended as a future gas injection well.

Seek - SEK (-6.4%)

SEK is the clear market leader in the Australian online employment advertising sector. It has built a dominant position over the past decade through strong branding and as a result of the structural shift from print to online advertising. SEK has diversified its earnings by increasing its presence in learning while also investing in high-growth foreign markets to sustain longer-term growth. SEK generates strong cashflows, has a flexible balance sheet and offers a fully franked dividend at a 45% payout ratio. With unemployment seemingly improving, SEK's earnings are expected to grow commensurately.

Healthscope - HSP (-5.5%)

Healthscope was informed Tenet has withdrawn from the formal process being conducted by Healthscope. The Company has been informed that this was in large part to end the speculation and rumours that have had a volatile and materially negative impact on the trading market for Tenet's securities. The Company further confirms that the formal process announced on 31 May 2010 is progressing. The Company's directors continue to recommend that shareholders take no action.

Emerging Portfolio Changes for the month

On 8th June:

- Increase weighting in AWE by 2.0%
- Increase weighting in MTS by 2.0%
- Decrease weighting in ANN by 1.0%
- Decrease weighting in RHC by 3.0%
- Add APA to the portfolio with weighting of 5.0%
- Reduce weighting in Cash (to part fund above transactions)

Corporate Actions

Nothing to report.

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