kinetic
INVESTMENT PARTNERS

Kinetic Wholesale Emerging Companies Fund

Fund report and commentary – 30 September 2011

Performance

	1 month (%)	Quarter (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Inception (%)
Kinetic Wholesale Emerging Companies Fund	**-8.59**	**-10.19**	**-0.98**	**6.69**	**-**	**-2.89**
Growth return	-8.59	-10.19	-1.00	4.97	-	-4.49
Distribution return	0.00	0.00	0.03	1.71	-	1.60
S&P/ASX Small Ordinaries Accumulation Index	-10.61	-11.79	-12.11	-0.14	-	-6.49
Active (Net)	2.02	1.60	11.13	6.83	-	3.60

Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance.

Investment objective

The Fund aims to outperform its benchmark, the S&P/ASX Small Ordinaries Accumulation Index, over rolling five-year periods.

Investment manager

Kinetic Investment Partners Limited

Investment strategy

Kinetic believes that inefficiencies exist in the small company sector of the market, and these inefficiencies predominately occur at the stock level.

Kinetic uses cash flow return on investment (CFROI) methodology to identify companies that it believes have been undervalued / undiscovered by the market. By focusing on cash flow, Kinetic minimises its exposure to accounting manipulations and changes in accounting standards.

Kinetic does not target a specific investment style.

Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

Asset allocation

	Current (%)	Range (%)
Securities	97	90-100
Cash	3	0-10

Top five active positions as at 31 August 2011

	Fund weight (%)	Index weight (%)	Active weight (%)
Ausdrill	3.71	0.76	2.95
Beach Energy	3.79	1.15	2.64
Thorn Group	2.63	0.00	2.63
SMS Management & Technology	2.75	0.40	2.35
Mermaid Marine Australia	2.99	0.65	2.34

Contributors (quarter) as at 30 September 2011

		Active weight (%)*	Value add (%)^
Top contributors	Beach Energy	3.49	0.75
	Saracen Mineral Holdings	2.27	0.60
	Red 5	0.99	0.51
Bottom contributors	Aurora Oil and Gas	1.98	-0.66
	Nanosonic	1.39	-0.38
	Sundance Resources Australia	-1.07	-0.30

*Active weights are daily averages over the period | ^Relative to benchmark and based on pre-fee returns.

Fund facts

	Kinetic Wholesale Emerging Companies Fund
Inception date	12/3/2007
Fund size ($M)	31.65
APIR code	HOW0036AU

Fees

	Kinetic Wholesale Emerging Companies Fund
Entry fee	Nil
2010/11 ICR	1.15%
Management fee	1.15% p.a.
Performance fee	20% of the Fund's gross return over and above the Index plus 1.15% p.a.
Buy/sell spread	+0.40%/-0.40%

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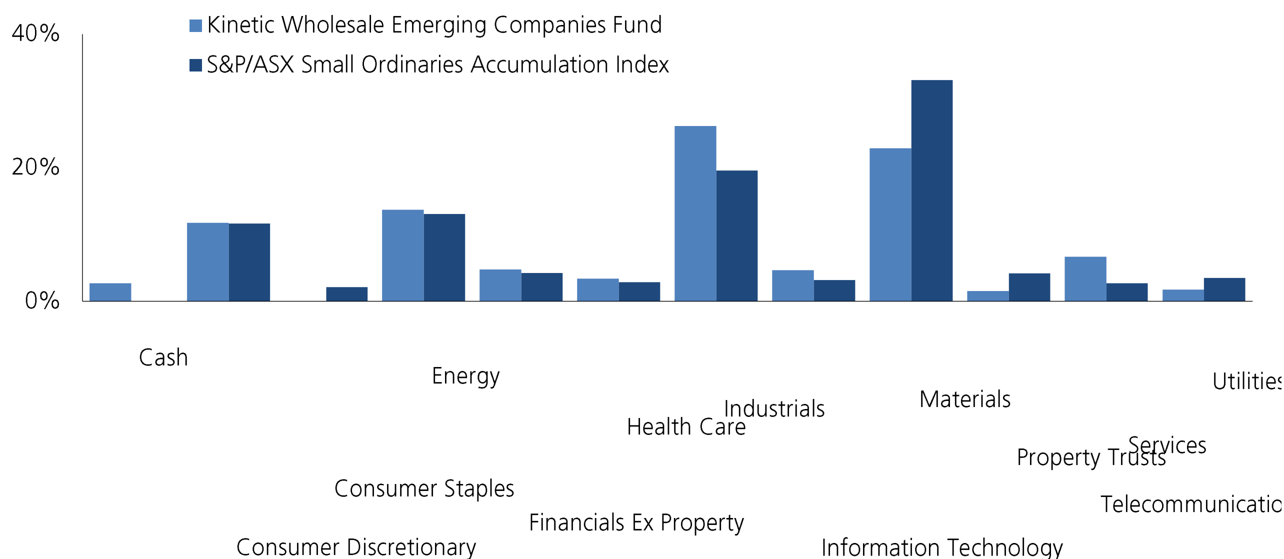
Sector exposures as at 31 August 2011



Commentary

The S&P/ASX Small Ordinaries Accumulation Index retreated 11.79% for the quarter, following the 9.31% retracement in the previous quarter, marking the largest pullback in the index since late 2008. Again the Small Industrials Index (-10.47%) slightly outperformed the Small Resources Index (-13.52%) over the quarter. For the quarter, the Small Cap Index performed in line with the S&P/ASX100 Accumulation Index, which was down 11.62%. This is despite a clear performance difference in the month of September when small caps slid 10.61% versus the S&P/ASX100 which retreated 5.8%.

Small caps continued to be weighed down by global macro issues. The focus remained squarely on sovereign debt issues in Europe with the market convinced the question was now when, not if, Greece will default. Again the spectre of contagion hung over the markets with the European Central Bank (ECB) forced to issue a statement that it had coordinated efforts with other central banks to extend three month US dollar (USD) loans to European banks on the back of rumours that French banks were having difficulty accessing funding.

Compounding the European debt issues was a string of generally weak US economic data, with the political standoff over raising the debt ceiling in the US playing out during the quarter. The issues in Europe and the US also cast doubt over whether China (and the other BRICS) could continue to show strong growth against a backdrop of global economic shocks.

The rise in risk aversion saw the Australian dollar lose almost 9% in September, ending the quarter below parity at 0.972 USD. Commodity prices also fell heavily in September, with copper and nickel down -20%, while oil and gold fell -10%. Domestically, the Reserve Bank of Australia held the official cash rate unchanged over the quarter at 4.75%, citing weak activity outside of the resources sector, with September showing the first signs of increasing unemployment (the unemployment rate moving up to 5.3% from 5.1% in August).

Results during the full year reporting season in August were generally in line with market expectations, with consumer facing stocks generally struggling. As such, the outlook for the retail, media and housing sectors remains weak with the only bright spot on the horizon being the now touted potential for interest rate cuts towards the end of this year. Although yet to play out, there are signs that business spend is also beginning to contract (which can be expected given the macro malaise). One sector that is yet to see any slowdown is mining services. However, if commodity pricing continues the downward trajectory seen in September, this sector may soon also come under pressure.

Post reporting season analysts' expectations for FY12 results have come back somewhat (from around 16% growth prior to reporting season to around 12%), but still look relatively bullish given the macro environment. The S&P/ASX Small Ordinaries Accumulation Index is currently trading around 11.9x rolling 12 month earnings versus the long term average of around 14x and the around 13x at the end of June 2011 (Citigroup estimates). On this basis, the small caps remain cheap by historical standards, even allowing for some moderation of growth expectations. However, until some of the macro headwinds have subsided, investors will probably remain parked on the sidelines.

The portfolio outperformed its benchmark over the quarter. Key contributors to returns were overweight positions in Beach Energy, Saracen Mineral Holdings and Red 5. Detracting from returns were overweight position in Aurora Oil & Gas, Nanosonic and an underweight position in Sundance Resources.

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Key contributors

Beach Energy: Beach Energy performed strongly in the period as the market began to realise the potential of the company's shale gas tenements in the Copper Basin.

Saracen Mineral Holdings: Saracen was up in line with a surge in gold prices seen in July and August. Towards the end of the period the company raised capital in order to fund a more aggressive exploration budget designed to bring production of the company's rich gold deposits forward.

Red 5: Red 5 was up after reporting solid progress on the construction of their Siana Gold Mine in the Philippines. The company confirmed construction remains on time and on budget with first gold pour expected in November 2011

Key detractors

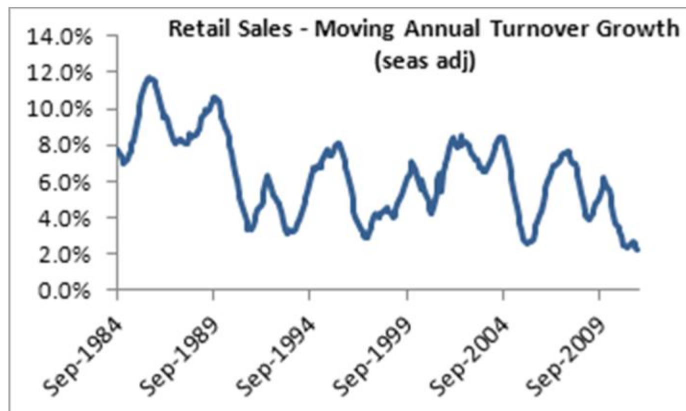
Aurora Oil & Gas: Aurora experienced some weakness post a strong rally in the preceding quarter as some heat came out of the US shale market. Kinetic believes that Aurora, with 90% of production output in oil and liquids, is well positioned for sustained growth in production in the next year.

Nanosonic: Nanosonic was weak in the period despite announcing the launch date for their Trophon product in the US and an upsizing of the initial order from distributor GE. The general market weakness experienced during the period did not augur well for non-profit generating companies and Nanosonic was caught up in this sentiment. Kinetic believes Nanosonic remains on track to provide meaningful earnings from the Trophon device.

Sundance Resources: Sundance rocketed in the period after it received a takeover approach from the Chinese based Hanlong Mining Group at a 45% premium to the one month VWAP at the time. Kinetic does not hold shares in Sundance.

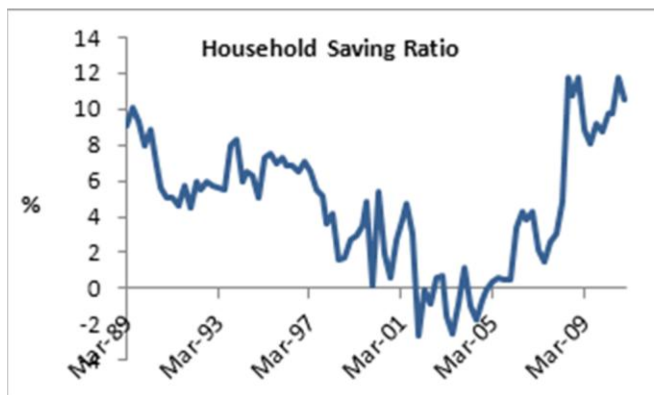
Hot topic: Retail – investment opportunity or value trap?

It's been a horror year for the retail sector, with stagnant sales, unrelenting discounting, several high profile bankruptcies and the rapid acceleration of the migration to online shopping. No wonder many seasoned retailers have described it as the worst 12 months in living memory. The cold, hard statistics don't lie either with total retail sales growth (on a 12 month moving annual total basis) running at the lowest rate seen in a generation.

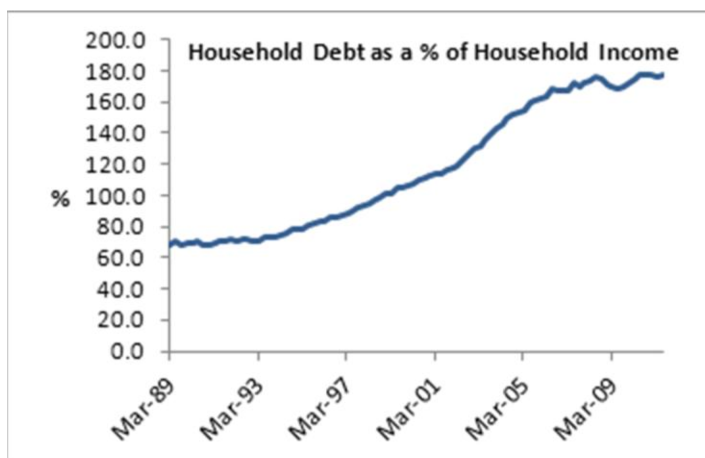


Source: ABS, Goldman Sachs and Partners Australia

Record household debt, depressed consumer sentiment, rising living costs, high interest rates, negative wealth effects from falling house and share prices, together with tight fiscal policy have all combined to keep shoppers out of stores. Depressed consumer spending has been mirrored by a significant lift in the household savings rate. The lift in the savings rate follows a 10 year period where savings were negligible or even negative where, by definition, consumers spent more than they earned. In this strong consumer environment, retailers thrived and margins were pushed up. With the likelihood that the household sector continues to deleverage, retailers face an ongoing headwind with consequent downward pressure on margins and returns. To cap it all, this ignores the effect of the internet, where online sales have started to explode as consumers have accessed cheaper goods online, particularly from overseas vendors. The local retail sector had hitherto been shielded from international competition but high local cost structures have now been savagely exposed. This online growth is reflected in the number of overseas retailers which have recently boosted their Australian internet presence and delivery capabilities. For example Bloomingdales, Macy's, Sears and John Lewis all now have a local online presence. Meanwhile Australia is the second ranked destination for global online sales from Topshop.com and ASOS.com reflecting the strong pick up in local internet shopping.



Source: ABS, Goldman Sachs and Partners Australia



Source: ABS, Goldman Sachs and Partners Australia

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Not surprisingly, given the negative environment described above, retail stocks have generally struggled over the past 12 months. This underperformance was especially marked within the top 100 stocks, with Billabong, Myer, Harvey Norman and David Jones all among the laggards on a total returns basis to the end of September 2011. Similarly within the small cap space, most retail stocks have lagged the index. Furthermore over the long term very few retailers have been able to build a sustainable competitive advantage such that they can consistently outperform the benchmark.

So that's the history lesson but what does the future hold for the sector? While it may be tempting to buy apparently 'cheap' retail stocks, at Kinetic we remain cautious on the outlook for the retail sector as a whole. Ongoing political uncertainty, overseas economic concerns, rising unemployment and subdued consumer sentiment are likely to mean that the savings rate remains relatively high and therefore retail spending remains subdued. The challenge presented by the internet and the grossly inadequate response to date by the local retailers to this threat, adds a further reason for caution. However beyond this blanket, rather negative view, there are still specific retailers which offer sound investment prospects. When assessing individual retail stocks, we favour companies with strong organic growth prospects (often driven by store rollouts), unique and strong brands, a strong and defendable online presence, healthy balance sheets and good management. In short we prefer retailers that can grow through the cycle, rather than those that are merely hostage to the cycle. When applying these filters, many of the larger, more mature retailers fall short. However several of the small cap retail stocks offer much better appeal. The one retailer that Kinetic has owned over the past year is Kathmandu which has posted exceptional sales and profit results despite the bleak economic backdrop. We continue to view Kathmandu's prospects favourably with store rollouts, a sound online strategy and excellent management all underpinning the investment case.

While we see selective opportunities elsewhere in the sector, we do believe many of the difficulties impacting on the retail sector are structural in nature and thus any potential cyclical rebound is likely to be short lived and quickly reversed. The internet shopping revolution in particular has laid bare high domestic rent and cost structures which are likely to see sales continue to move offshore, to the detriment of the local players.

Outlook

While the market undeniably faces headwinds across several fronts, the recent pullback in the sharemarket has pushed the market into relatively cheap territory on a historical basis. At a broad level, the ultimate conclusion of debt and policy issues in Europe and North America will undoubtedly play a major role in determining the market's direction. In particular, how growth is impacted in China and the rest of Asia will directly impact on the outlook for the resources sector.

The outlook for the local economy is similarly somewhat mixed. Soft consumer spending is likely to continue although a forecast cut in interest rates may bring some relief. Ongoing political instability is likely to also weigh on domestic demand. While some slowdown in Chinese growth cannot be discounted, we expect growth to remain sufficient to buoy commodity prices and the resources sector as a whole. Ongoing merger and acquisition activity in the sector will also support share prices.

In an overall sense we are relatively optimistic as present valuations appear attractive and we expect a 'soft landing' for the global economy. Risks to this outlook hinge around the failure to resolve the sovereign debt issues and the potential for inflationary pressures in China to force a greater than expected slowdown.

Any information contained in this publication is current as at 30/09/11 unless otherwise specified and is provided by Challenger Managed Investments Limited ABN 94 002 835 592 AFSL 234 668, the issuer of the Fund. It should be regarded as general information only rather than advice. It has been prepared without taking account of any person's objectives, financial situation or needs. Because of that, each person should, before acting on any such information, consider its appropriateness, having regard to their objectives, financial situation and needs. Each person should obtain a Product Disclosure Statement (PDS) relating to the product and consider that PDS before making any decision about the product. A copy of the PDS can be obtained from your financial planner, our Investor Services team on 13 35 66, or on our website: www.challenger.com.au. If you acquire or hold one of our products, we will receive fees and other benefits, which are disclosed in the PDS for the product. We and our employees do not receive any specific remuneration for any advice provided to you. However, financial advisers (including any Challenger group companies) may receive fees or commissions if they provide advice to you or arrange for you to invest with us. Some or all of the Challenger group companies and their directors may benefit from fees, commissions and other benefits received by another group company.