Kinetic Wholesale Smaller Companies Fund (CNA)[1]

Quarterly fund report and commentary – 31 December 2011

Performance[2]	Quarter (%)	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	Since inception (% p.a.)
Fund	**1.97**	**-11.47**	**21.54**	**-0.99**	**9.78**	**10.66**
Growth return	1.97	-13.29	19.01	-10.89	-5.17	-2.75
Distribution return	0.00	1.82	2.53	9.90	14.95	13.41
S&P/ASX Small Ordinaries Accumulation Index	-0.60	-21.43	11.82	-5.18	6.48	6.08

Past performance is not a reliable indicator of future performance.

[1] The Fund is closed to new investments including initial and additional applications.

[2] Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures.

Investment objective

The Fund aims to provide capital growth over the medium to long term through an actively managed and diversified portfolio of Australian small company shares, and provide returns above the S&P/ASX Small Ordinaries Accumulation Index, over rolling three-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 predominantly occur at the stock level.

Kinetic does not target a specific investment style. Kinetic uses cash flow return on investment (CFROI) methodology to identify companies that it believes have been undervalued or undiscovered by the market.

Distribution frequency

Yearly

Suggested minimum investment timeframe

At least five years

Asset allocation	As at 31 December 2011 (%)	Range (%)
Securities	98	90-100
Cash	2	0-10

Top five active positions as at 31 December 2011	Fund weight (%)	Index weight (%)	Active weight (%)
Beach Energy	4.71%	1.53%	3.17%
Aurora Oil and Gas	4.58%	1.56%	3.01%
Ausdrill	3.56%	0.84%	2.72%
Austbrokers Holdings	2.40%	0.00%	2.40%
Saracen Mineral Holdings	2.69%	0.43%	2.26%

Contributors for the quarter as at 31 December 2011		Active weight (%)[1]	Value add (%)[2]
Top contributors	Aurora Oil and Gas Limited	3.01	1.07
	Beach Energy Limited	3.17	0.53
	Campbell Brothers Limited	1.52	0.51
Bottom contributors	Talent2 International Limited	0.00	-0.70
	CSG Limited	0.58	-0.45
	SMS Management & Technology Limited	1.86	-0.36

[1]Active weights are monthly averages over the period.

[2]Calculated monthly relative to benchmark and based on pre-fee returns.

Fund facts	Fund
Inception date	31/10/1994
Fund size ($M)	8.9
APIR code	HBC0006AU

Fees	Fund
Entry fee	Closed to investments
2010/2011 ICR	0.82%
Management fee	0.768%p.a.
Normal operating expenses	Recovered from the Fund
Buy/sell spread	+0.20%/-0.20%

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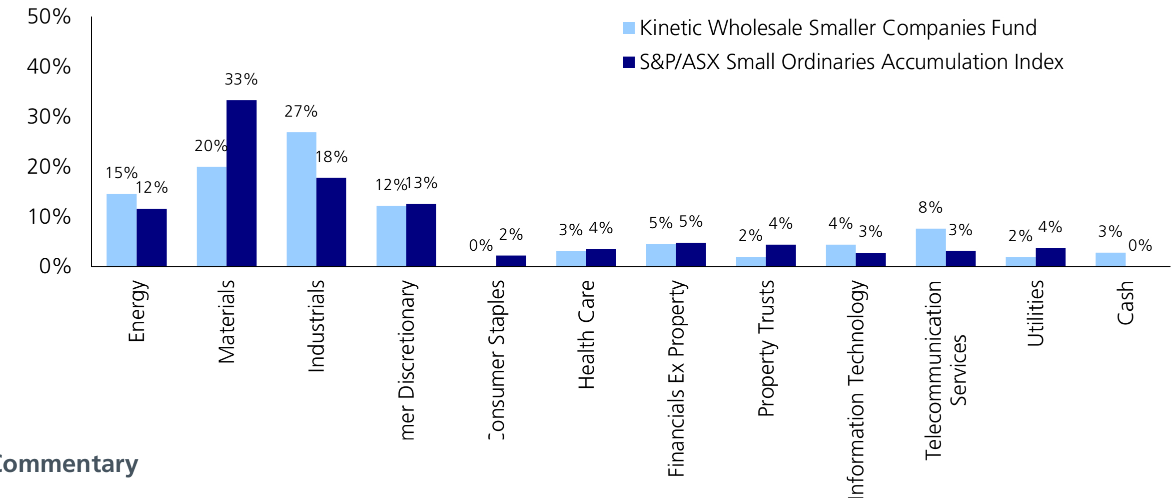
Sector exposures as at 30 November 2011



Commentary

The Australian Small Caps market (S&P/ASX Small Ordinaries Index) finished the quarter down -0.6%, underperforming the broader equities market as risk aversion continued to drive performance. Calendar year 2011 returns also saw small caps (-21.4%) lag their large cap counterparts (-11.0%) by a fairly significant margin. Within Small Caps, Small Industrials (0.0%) outperformed Small Resources (-1.4%) over the quarter.

Economic indicators were mixed with the US market continuing to improve (the S&P 500 being up 11.1% for the year), buoyed by the housing market beginning to show signs of life and clear improvements in the labour market.

Major European markets also finished the quarter up as investors were encouraged by the European central bank's long term refinancing operations designed to increase eurozone bank liquidity, although the strong quarterly performance failed to offset previous declines over the year.

Oil prices rose +24.82% against a backdrop of geopolitical tensions and threats to supply, while commodity prices appeared to soften due to fears of a slowdown in demand from China. Manufacturing in India and China did improve in December; a sign that Asian economies were holding up despite turmoil in global markets.

However, on the domestic front the quarter saw a raft of downgrades in the retail, finance and housing/developers sectors and there were signs of deterioration in early cycle segments such as recruiters and IT services. The two-speed economy was again clearly evident with resource service companies bucking the trend and announcing upgrades and project wins in the period.

The Reserve bank of Australia (RBA) cut its official interest rate by 25 bps on two separate occasions over the quarter, citing a lower inflation outlook and deteriorating conditions in Europe. Consumer confidence fell by a significant 8.3% in December, reversing several months of improvement to be significantly below trend. Housing finance continued its weakness during October, rising by just 0.7% over the month with most activity concentrated in the refinancing of existing dwellings. The Australian employment market showed further signs of weakening over the quarter, with the unemployment rate rising to 5.3% in November, from 5.2% in October. The AUD/USD finished the month and year broadly unchanged at 1.02 despite high volatility, which saw the currency swing from 0.98 to 1.04 in December and from 0.94 to 1.11 across 2011.

The portfolio outperformed its benchmark over the quarter. Key contributors to returns were overweight positions in Aurora Oil and Gas (up 51.23%), Beach Energy (up 13.38%) and Campbell Brothers (up 18.86%). Detracting from returns were overweight positions in CSG (down 44.37%), SMS Management & Technology (down 16.44%) and Talent2 International (down 57.45%).

Key contributors

Aurora Oil and Gas: 51.23%
Aurora outperformed after the company announced some positive production and reserve estimate results for the 3rd Quarter. Also in the period, the price of oil spiked from year end lows of just above USD75 a barrel to finish the year around the US$100 a barrel mark.

Beach Energy: 13.38%
Beach Energy's stock continues to outperform as the market becomes increasingly excited about the prospects of the company's shale gas operations in the Cooper Basin. The company also benefited from the strong rebound in the oil price and completed the acquisition of complementary asset holder Adelaide Energy.

Campbell Brothers: 18.86%
During the period CPB announced record results for the half year ended September 2011, reporting a 54% increase in NPAT (on p.c.p), driven by 22% growth in revenue and continued margin improvement. The company also announced a continuation of strong market conditions since September and upgraded its full year guidance. Kinetic is currently selling down our position in CPB as the company entered the ASX100 in September 2011.

Key detractors

Talent2 International: -57.45%
Towards the end of the period, Talent2 downgraded earnings estimates for the half year. Both the quantum and composition of the downgrade took the market, Kinetic and seemingly management by surprise. Kinetic have exited our position in Talent2 as the managed services part of the business has proven to be much more cyclical than envisaged, thus removing the basis of the investment thesis in the stock.

CSG: -44.37%
CSG was weaker after an indicative offer for the company, received in September, failed to materialise into a full bid. The company also stated that the bid process had been distracting to both staff and clients, thus leaving the door ajar for further downgrades at the upcoming half year results. Kinetic continues to hold CSG as we believe the intrinsic value of the company's operations far exceeds the current trading price.

SMS Management & Technology: -16.44%
SMS lagged the market in the period as concerns grew that weakening demand for IT services would result from increased instances of project deferrals and cancellations. Also in the period, SMS stated that their NSW operations had suffered from sub-optimal utilisation levels in the 1st quarter. Kinetic believe SMS are well placed to navigate through the current patchy market conditions and set the company up for another leg of sustained growth.

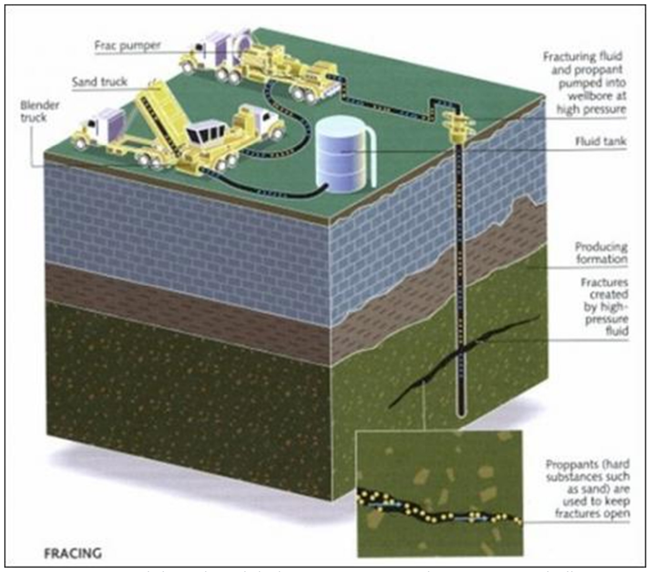
Thought piece – Shale Gas – A New Frontier in Energy Supply

It was only a few of years ago that there were growing fears that the world was potentially getting close to peak supply in fossil fuels. Naturally the ramifications would be devastating to world growth; impacting transport, heating, materials, electricity and food supply. However substantial advances have been achieved in hydrocarbon extraction technologies, alongside improving visualisation and mapping techniques which have resulted in the discovery of substantial resources that could radically change global thinking about energy security. One area of great advance has been the unconventional unlocking of gas and oil from shale rock, which incidentally a number of listed Australian companies have been exploiting.

The substantial improvement in unconventional gas extraction has the potential to unlock a significant energy supply for generations to come. In a recent publication, ExxonMobil has stated that by 2040, unconventional gas will account for 30% of global gas production, up from 10% in 2010. Moreover, the application of new technologies to these unconventional supplies has helped unlock up to 250 years of global gas supply at current demand levels.

So what is shale? It is formally defined as fine-grained sedimentary rock that has natural gas (and condensate) trapped within its formation. The rocks have extremely low permeability and require specialised techniques to liberate the gas which is performed by hydraulic fracturing (fracking). This methodology uses a specially designed fracturing fluid that is pumped under high pressure into the shale formation. The process creates fractures in the rocks deep underground that are propped open by sand which allows the natural gas to flow into a well.

When geologists assess the viability of gas extraction from shale they consider certain characteristics including sedimentary composition (marine or forest), the thickness of the shale, permeability (ability of the gas to pass through the shale), porosity (measure of void spaces within the formation) and total organic carbon content in the shale.



Source: "Sustainability, The Global Economic Crisis" by Stuart Bramhall, 2011

Kinetic's medium-term view of the market is relatively optimistic. The upswing in the global economy (ostensibly Asia) will continue to support the resources sector. The flow-on effect to the local economy augurs well for small company profitability. Moreover there is likely to be ongoing merger and acquisition activity in the resources sector as Asia looks to grow its strategic assets base, assuming a moderating Australian dollar. On the domestic front, a somewhat extended period of stagnant interest rates may see the return of the consumer, albeit in a more sedate form than previously. On the housing front, some growth from the current low base is expected towards the end of this year, with muted growth into 2012.

However, Kinetic remain cognisant of the risks to the outlook including the continuation of sovereign debt issues, which have the potential to constrain fiscal activity and stymie global growth and the risk that US economic malaise may take some years for the labour market and hence the consumer to recover. In addition, inflationary pressures and some signs of property oversupply in China could exacerbate volatility.

The media has highlighted some environmental concerns regarding shale fracking. One concern that has been highlighted is that fracking might contaminate the groundwater. However, at Kinetic we only favour operations that are well away from a water table or aquifers and, assuming the well is properly cased, there is very little risk of contamination. The other concern is that poorly cased wells allow gas to escape to underground aquifers. The reality is that water wells which are drilled in shallow coal seams can have traces of biogenic gas (from coal), but never from the much deeper shale gas. Hence, shale gas can have inherent environmental benefits over coal seam gas.

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A key thematic that has arisen following the discovery of shale gas resources is that the most significant discoveries have been found in two nations that have been dependant on gas importation; China with 1275 trillion cubic feet or (TCF) of potential recoverable shale gas resources and the US (862 TCF). This has potential ramifications for gas exporting nations (including Australia) if these two nations are able to become gas (energy) self-sufficient. Already, the US has a domestic supply glut owing to heavy investment in the production of shale gas in states such as Texas. US company Cheniere Energy has signed two long-term supply contracts and is about to start construction of a proposed LNG export terminal.

If China grows its gas reserve base significantly that could potentially impact the seaborne market of liquid LNG to China. To put the size of the potential resource base in perspective, it is estimated that Asian demand for LNG by 2025 will be roughly 11 TCF (Core Energy Group 2011), compared to China's gas potential of 1275 TCF over 100 years!

Kinetic has invested in this burgeoning sector through exposure to three types of shale gas and/or oil ventures; Aurora Oil and Gas which is a liquids-rich shale play in Texas, Beach Energy that has discovered a substantial deposit of shale gas in the Cooper Basin and Entek Energy which is an early stage developer of gas and liquids in the Niobrara shale, Colorado. All three of these businesses have the potential to discover substantial hydrocarbon resources using the cutting-edge methodologies for shale hydrocarbon extraction.

Aurora Oil and Gas (AUT)
This investment provides a pure exposure to the liquids-rich Eagle Ford shale in the US state of Texas. We anticipate the high level of development drilling next year could result in AUT being the fastest growing oil and gas producer listed on the ASX. Furthermore, reserves are anticipated to grow substantially though closer drill spacing, continued fracking optimisation and drilling multiple seams. Reserves are currently 83mmboe 3P and we expect that to imminently convert to 2P.

Beach Energy (BPT)
In the last few years BPT has managed to accumulate over 1600km2 of prospective shale acreage in the Cooper Basin. Whilst it is too early to determine the commerciality of the shale gas project, all data points have been positive including substantial shale thickness, gas saturation, over pressuring and strong gas flows.

The size of the resource could be enormous, with potential gas in place of over 300TCF, which even at 20% recoverability equates to 60TCF of deliverable gas to market. Subject to the costs of drilling, fracking and piping the out the gas, this could be a multiple billion dollar project. In the domestic market 1TCF of gas at today's prices would generate roughly $3-4 billion in revenue.

Entek Energy (ETE)
ETE is shortly about to embark on a 3 well test program into the Niobrara shale that has exhibited unstimulated oil flow from natural fracturing. Results from the test program should enable optimal fracture stimulation design; a key value driver for the company. Alongside existing drilling in the shale from other corporates, our view is an eventual proving up of the resource should add substantial value to ETE.

Fund outlook

The playing out of the sovereign debt issues in Europe will likely dictate the near term movements in the market. Any credible resolution to the European debt issues and consequent reduction in credit spreads could set the stage for a market rebound. Asia has been impacted by the uncertainty in Europe and that is likely to be reflected in earnings over the next six months. However, we are still optimistic about growth in the region. Inflation is under control in China and hence the government has scope to stimulate the economy (through the easing of lending policy). Another reason for optimism has been continued evidence of resilience in the US recovery. We expect global demand growth to remain sufficient to buoy commodity prices and the Resources sector as a whole. Ongoing M&A activity in the sector will also support share prices.

The outlook for the local economy continues to be somewhat cautious. Soft consumer spending, weak housing activity, tight fiscal policy and a pick-up in the unemployment rate are likely to continue to weigh on the domestic economy. While recent rate cuts will provide some positive stimulus, monetary policy tends to act with a significant lag. Ongoing political instability is likely to also weigh on domestic demand.

In an overall sense we are relatively optimistic as present valuations appear attractive and we expect a "soft landing" for the global economy. The risk to this outlook hinges around the failure to resolve the sovereign debt issues in Europe.

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