

# Quarterly Performance Report as at 31 December 2011

Solaris Core Australian Equity Fund APIR WHT0012AU

## Market & Sector EPS Growth (%)

Pro-rated to June	FY11E	FY12E	FY13E
All Companies	18.2%	10.3%	8.8%
Banks	10.9%	6.3%	4.6%
Listed Property Trusts	2.4%	-1.2%	4.9%
Resources	65.4%	17.2%	10.4%
Industrials (ex Banks & Property)	0.3%	10.6%	12.6%

Source: Solaris Research, December 2011

## Market & Sector PEs (x)

Pro-rated to June	FY11E	FY12E	FY13E
All Companies	12.1	11.0	10.1
Banks	10.5	9.8	9.4
Listed Property Trusts	11.3	11.4	10.9
Resources	11.9	10.3	9.3
Industrials (ex Banks & Property)	14.1	12.7	11.3

Source: Solaris Research, December 2011

## Market & Sector Dividend Yield (%)

Pro-rated to June	FY11E	FY12E	FY13E
All Companies	5.0%	5.3%	5.6%
Banks	7.0%	7.4%	7.7%
Listed Property Trusts	6.8%	6.7%	7.0%
Resources	2.4%	2.6%	2.9%
Industrials (ex Banks & Property)	5.3%	5.6%	6.1%

Source: Solaris Research, December 2011

## Market Review

The S&P/ASX200 Accumulation Index gained 2.1% in a volatile December quarter, with the ebb and flow of equity markets dictated by the fiscal crisis in Europe. In its latest move, the EU agreed new measures to control government borrowing at a summit in December, as well as providing further funding support via the IMF and a plan to introduce the European Stability Mechanism earlier than originally planned. Economic indicators in the euro-zone continued to deteriorate whilst US economic data showed a firming of momentum. Locally, Resources (-2.6%) were affected by weaker commodity prices and concerns over Chinese growth expectations, which led The People's Bank of China to announce a cut to its Reserve Requirement ratio. Banks (6.6%) outperformed as wholesale funding pressure and rising credit spreads eased from November highs.

Corporate commentary during the quarter was on balance downbeat, with profit warnings from retailers before Christmas, including Billabong International Limited, JB Hi-Fi Limited and Kathmandu Holdings Limited.

### S&P/ASX200 Top & Bottom performing sectors for December quarter:

The best performing sectors in the S&P/ASX200 Accumulation Index for the quarter were Commercial Services & Supplies (13.0%), Utilities (8.1%) and Telecommunication Services (6.9%). The worst performing sectors were Consumer Durables & Apparel (-27.5%), Retailing (-14.8%) and Materials (-3.1%).

### S&P/ASX200 Top & Bottom performing stocks for December quarter:

The top-five performers in the S&P/ASX200 Accumulation Index for the quarter were Karoon Gas Australia Limited (58.2%), Aurora Oil & Gas Limited (51.3%), Transpacific Industries Group Limited (47.3%), Hastings Diversified Utilities Fund (34.4%) and Cochlear Limited (33.6%). The bottom-five performers were White Energy Company Limited (-74.3%), Billabong International Limited (-46.7%), OneSteel Limited (-43.5%), Linc Energy Limited (-42.7%) and OM Holdings Limited (-42.0%).

## Economic News

Over the last two months and for the first time in eleven months the RBA reduced the cash rate to 4.25% in two 25bps intervals. The board cited sovereign debt stress in Europe and the risk posed to the global and domestic economies. The unemployment rate remained steady at 5.3%, with 29,500 jobs added between August and November.

## Outlook

At the time of writing, the US economy continues to show encouraging signs despite the ongoing debt concerns in Europe. Manufacturing output increased the most in six months, with the Institute of Supply Managements purchasing managers index rising to 53.9 in December from 52.7 in November. China's official PMI also moved from contraction to expansion, rising to a better-than-expected 50.3 in December. In Europe, the ECB lowered its key interest rate by 25bps for the second time in two months, as S&P and Fitch put six countries on credit watch keeping investors wary.

Locally, consumer confidence declined 8.3% in December, reversing the 6.3% rise in November and forcing it to track below trend. This is despite the two RBA interest rates cuts and ensuing profit downgrades in the retail sector late in December. On the other hand, domestic manufacturing recorded expansion for the first time in six months, with the Australian PMI reaching 50.2 from 47.8 in November.

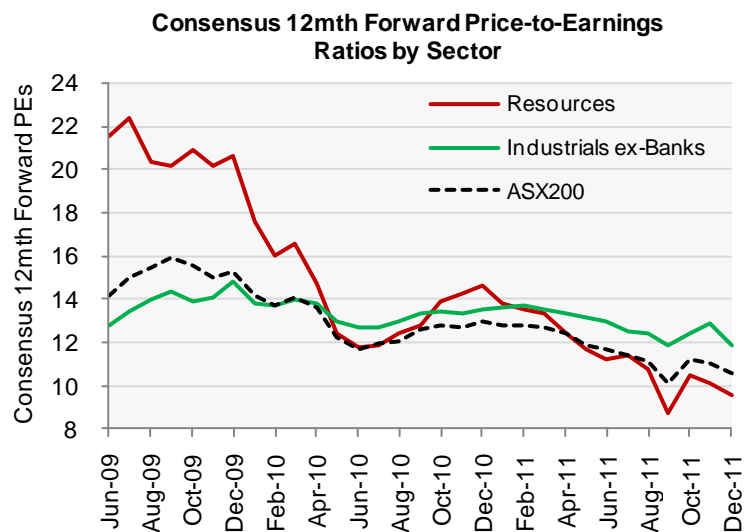
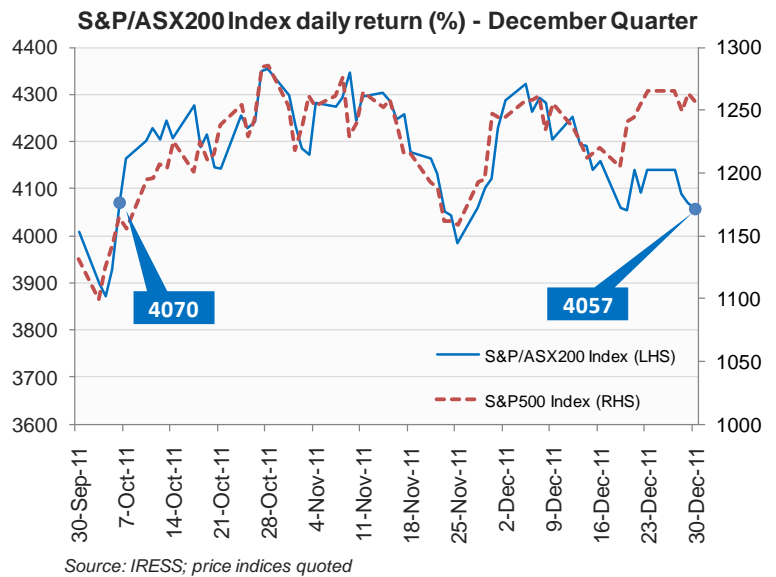
### US shows signs of recovery, whilst Australian economy slows

The Australian equity market finished 2011 at a level reached in early October (see chart at top-right). In contrast, the S&P500 clawed back most of its third quarter losses in the final quarter of the year, mainly on the back of a firmer tone to economic data pointing to resilience in the US economy.

The Australian market continues to appear cheap, with equity risk premiums back to GFC levels in 2011. The market is pricing in a large amount of uncertainty from the threat Europe's ongoing fiscal problems pose to the global economy, as the forward price-to-earnings ratios suggest (see chart bottom-right). These fears have translated into the two RBA interest rate cuts in November and December. The slowing economic momentum in the domestic economy suggests further interest rate cuts are likely to follow early in 2012.

Nonetheless, policy action and the prospect of further measures has meant the balance of global risks have eased over the past three months. In the US, GDP and profit growth continues to improve and in China, the inflation risks appear to have eased giving the authorities room to move on monetary policy. The euro-zone still faces significant structural problems, but has finally begun taking the first steps in the process of reform.

In these circumstances, Resources and cyclical stocks, which are leveraged to the global economy, could see growth in EPS if commodity prices recover. Earnings for Industrials shares (ex-Banks) could take longer to recover this early in the interest rate cutting cycle. The weakening economy increases the likelihood that EPS growth will continue to trend down.



## Fund Performance

The portfolio underperformed its benchmark this quarter by 0.30%. Overweight positions in AWE Limited, QR National Limited and Stockland were the top contributors and made a positive contribution to relative performance. The main detractors were overweight positions in BlueScope Steel Limited, ResMed Inc and Henderson Group.

Returns	Month	Rolling Quarter	6 Months	1 Year	2 Years p.a.	3 Years p.a.	Since Inception p.a. (17/09/2008)
Fund Gross Return	-1.36%	2.08%	-11.20%	-11.12%	-6.19%	7.17%	0.40%
Benchmark Return*	-1.35%	2.12%	-9.71%	-10.54%	-4.68%	7.58%	-0.23%
Outperformance	-0.01%	-0.04%	-1.49%	-0.58%	-1.51%	-0.41%	0.63%
Fund Net Return	-1.46%	1.82%	-11.65%	-11.98%	-7.09%	6.13%	-0.50%
Benchmark Return*	-1.35%	2.12%	-9.71%	-10.54%	-4.68%	7.58%	-0.23%
Outperformance (After fees)	-0.11%	-0.30%	-1.94%	-1.44%	-2.41%	-1.45%	-0.27%

\* S&P/ASX 200 Accumulation Index

The performance data above is based on month end prices before tax. Net performance is calculated after management fees and operating costs, excluding taxation. Gross performance is stated excluding all fees, cost and taxation. This is historical performance data. It should be noted the value of an investment can rise and fall and past performance is not indicative of future performance.

## Significant Contributors & Detractors

### AWE Limited (30.8%)

AWE performed very well during the quarter following an update on operations and production within the Sugarkane Gas and Condensate Field in the US and the sale of part of their Bass Basin portfolio. As part of the asset sale, AWE announced a 5c special dividend. Adding to the enthusiasm were some investor presentations in Australia highlighting the benefits of investing in shale gas in Australia. AWE also has an interest in a shale gas field in the Perth Basin, which they will look to drill in the next few months.

### QR National Limited (8.2%)

QR National released a trading update at their maiden AGM in November where they reaffirmed FY 2012 earnings before interest and tax (EBIT) guidance of \$578 million on 200-210mt of coal hauled (versus prospectus forecast 233mt). The lower revenue from coal haulage will be made up for by higher cost reductions than previously expected. Queensland coal mines have seen coal production ramp back up in the second quarter of FY 2012 after a poor start to the year due to excess water in the mine pits.

### Stockland (9.6%)

Stockland was strong during the quarter as defensive stocks outperformed and the investor day held by the company reiterated their earnings outlook and reported that the residential landscape is “steadily improving so far this year.”

### BlueScope Steel Limited (-34.5%)

In a surprise to the market, BlueScope announced a \$600 million 4-for-5 renounceable rights issue at 40 cents per share. The proceeds of the issue were used for debt reduction. The company revealed that its debt position had increased by \$487 million to \$1.5 billion due to a working capital increase of approximately \$230 million since the end of June 2011. The company is still targeting a working capital decrease of \$400-500 million in FY 2012. BlueScope reaffirmed earnings guidance at its AGM in November, forecasting a small underlying net loss after-tax and a significant statutory net loss after-tax, due to accounting for the restructuring costs from closing blast furnace number 6 at Port Kembla.

### ResMed Inc (-16.0%)

ResMed was a significant underperformer following the release of their first quarter FY 2012 result in October. The company reported a 3% decline in US flow generator sales. The market expected a recovery in US flow generator sales following three quarters of weak growth. Management noted poor sales in its low-end product segment due partly to soft macroeconomic conditions, a mix shift towards higher-end products and the exit of unprofitable business. Gross margins did surprise, up 60 basis points on the fourth quarter of 2011.

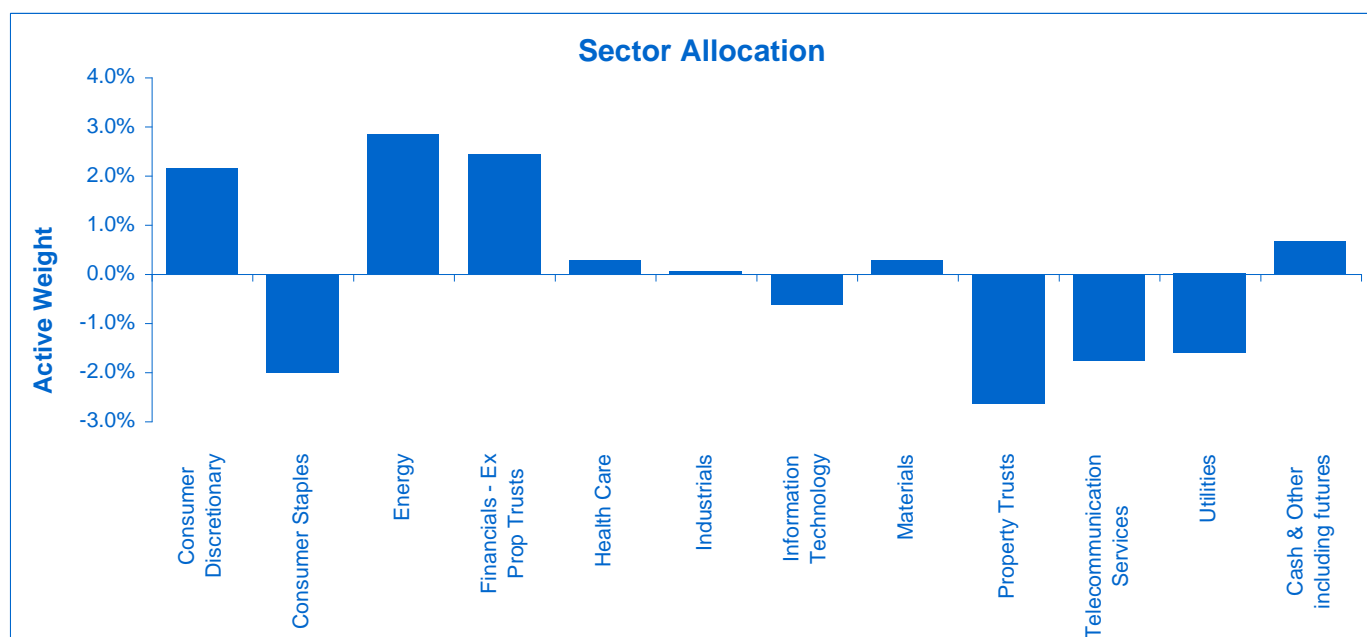
### Henderson Group (-8.4%)

Henderson Group provided a trading update for the September quarter confirming that funds under management had fallen following adverse market movements and some net outflows. Assets under management fell by £9.0 billion to £65.4 billion, marginally below expectations.

## Top 10 Stock Holdings

Stock Name	Sector
BHP Billiton Limited	Materials
Commonwealth Bank of Australia	Financials - Ex Prop Trusts
National Australia Bank Limited	Financials - Ex Prop Trusts
Westpac Banking Corporation	Financials - Ex Prop Trusts
Australia and New Zealand Banking Group Limited	Financials - Ex Prop Trusts
Rio Tinto Limited	Materials
Origin Energy Limited	Energy
Telstra Corporation Limited	Telecommunication Services
Woolworths Limited	Consumer Staples
QR National Limited	Industrials

## Sector Allocation



**Incitec Pivot Limited**

Incitec Pivot is a chemicals and explosives company. In terms of revenue, Incitec is the largest manufacturer and supplier of fertilisers in Australia, the largest supplier of explosives in North America (the largest explosives market in the world) and the second-largest supplier of explosives in Australia (the third-largest explosives market). The company was formed as the result of a merger between Incitec Fertilizers and the Pivot group and substantially expanded with the acquisition of Southern Cross Fertilisers in 2006 and Dyno Nobel in 2008. Today the company's earnings are evenly split between fertiliser and explosives.

**Fertilisers**

Incitec manufactures fertiliser for both export and distribution locally. Incitec produced 1.9 million tonnes of fertiliser in 2011 with nearly half being Phosphate based and the other half Nitrogen based. The primary driver of fertiliser earnings are fertiliser prices (Di-Ammonium Phosphate and Urea) and volumes. Volumes are dependent on favourable seasonal conditions and attractive soft-commodity prices (for example, corn and wheat).

The earnings for the Incitec fertiliser businesses are highly leveraged and volatile (see top-chart right). Earnings are skewed to the second-half of the financial year, in-line with the winter crop in Australia and the summer crop in the US. A plus-or-minus US\$10/t move in the Urea price equates to a plus or minus \$4.1 million in earnings before interest and tax (EBIT), while a plus or minus US\$10/t move in Di-Ammonium Phosphate (DAP) equates to plus or minus \$9.7 million in EBIT.

In recent years, the rapid rise in living standards in two of the world's most populous nations, China and India, as well as poor seasonal conditions in the Northern Hemisphere has led to strong soft-commodity prices. Soft-commodity prices have a strong correlation to fertiliser prices (see middle-chart right).

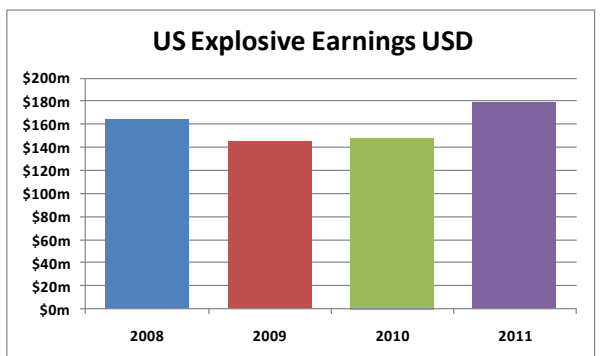
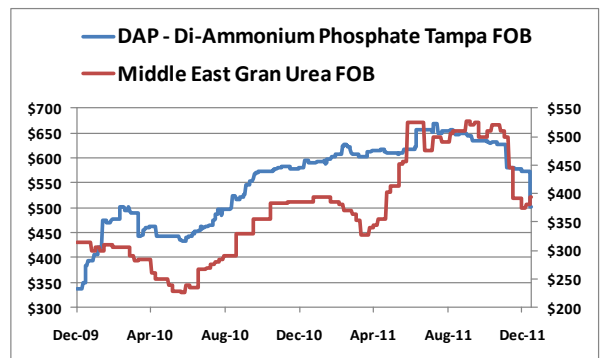
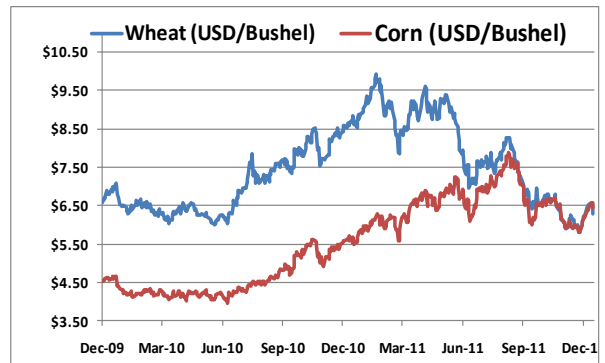
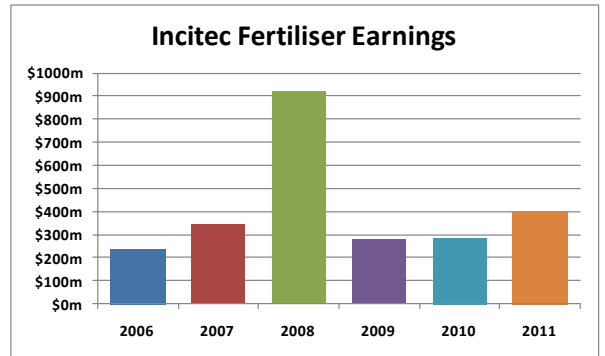
The DAP and Urea prices have been very strong in the past six months leading to upgrades in earnings from analysts. However, more recently fertiliser prices have come under pressure as economic conditions in Europe deteriorating and weakness in soft-commodities persisting. The December quarter is traditionally weak for fertiliser prices, however if the current fertiliser prices continue (see bottom-chart right) then we may see some moderating of earnings expectations for the fertiliser business.

While fertiliser prices can provide a volatile earnings stream, Incitec have been steadily building a defensive earnings stream via the explosive business.

**Explosives**

Dyno Nobel (Dyno) was purchased by Incitec in 2008 following a brief period as a listed company. Dyno Nobel is the market leader in North America, the largest explosives market in the world, and the second largest supplier in Australia, the third largest explosives market in the world.

The US explosives business (Dyno US) suffered during the global financial crisis (GFC) with earnings falling. Dyno US is exposed to three segments of the market being Quarrying & Construction,



Coal and Metals & Mining. All segments were weak during the GFC with Quarrying & Construction being the most affected and still remains subdued. The Coal segment has recovered and is delivering moderate growth, with Metals & Mining now delivering very strong growth.

The most exciting market for Dyno is the fast growing Metals & Mining sector in Australasia. Construction of the Moranbah Project in Queensland that will produce 330ktpa is running on time (commissioning is July 2012) and on budget (\$935 million). The project is currently 90% complete. This project will transform Dyno's Asia Pacific explosives business and management expects it to achieve \$165 million of EBIT in FY 2015.

Explosive growth is expected to be strong for the foreseeable future due to demand for commodities from the developing world and increased overburden associated with mining the ore. With this in mind Solaris expects to see strong volume growth and higher prices in the next few years.

In addition to Moranbah, Incitec is looking at further projects to meet the growing needs of the mining industry including an explosive plant at Kooragang Island (feasibility study to begin soon) in Newcastle, an emulsion plant in the Pilbara, and potentially a Moranbah 2 in Queensland. The majority of any new projects will be commissioned in the latter half of this decade adding little to earnings growth in the next three years.

### **Balance Sheet**

The balance sheet of Incitec is solid with gearing around 30% and healthy interest cover in FY 2012 expected to be approximately 12x. Post the Moranbah capital expenditure, and in the absence of the growth project mentioned above, Incitec will generate substantial free cash flow in FY 2013. Excess funds will be returned to shareholders if they can't be invested based on Incitec's strict investment criteria.

### **Outlook**

Solaris is expecting Incitec to deliver flattish earnings per share growth in 2012 and 2013 implying a price earnings ratio of 10.0x. Stronger explosive earnings are expected to be offset against lower fertiliser earnings in the future.

## Fund Ratings



Highly Recommended

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### Solaris Core Australian Equity Fund



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WINNER  
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Fund Manager of the Year  
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