



**Australian Leaders Fund**

Level 11, 139 Macquarie Street  
NSW Sydney 2000

**TEL** (02) 9362 8606 **MOB** 0400 999 910

[braitling@braitlinginvestments.com.au](mailto:braitling@braitlinginvestments.com.au)

[www.australianleaders.com.au](http://www.australianleaders.com.au)

ABN 64 106 845 970

# The LeadingEdge

QUARTERLY REPORT | **January 2008**

In the current addition of The Leading Edge we want to share with you some insights into recent market volatility, look closely at the credit crisis that has gripped financial markets and review the implications for the economy and asset pricing more broadly.



# The Credit Crisis in Perspective

From midway through last year, credit markets tightened with a sharp reversal in the favourable credit conditions that have prevailed for many years. The impact has been felt across most asset and debt markets with liquidity drying up and volatility increasing appreciably.

The environment improved in October as the prospect of systemic risk to the financial system abated, with central banks the world over offering short term liquidity on favourable terms. The US Federal Reserve lowered rates by 50 basis points on the 18th September 2007 indicating they would act preemptively in relieving stress in credit markets. Around the same time US banks started reporting large losses on impaired subprime mortgages, providing visibility on the scale of the problem.

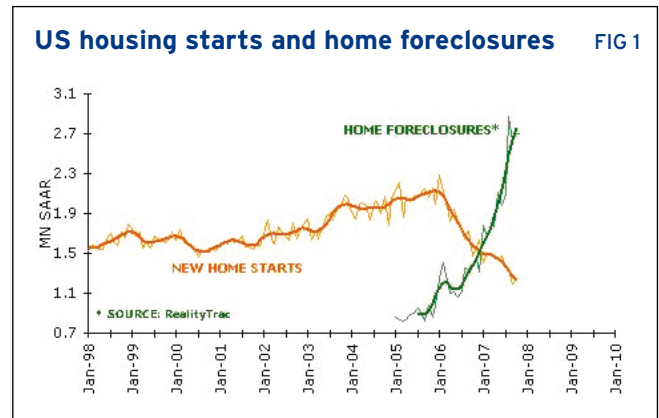
By late October however debt markets took a turn for the worse as a wave of downgrades from various credit agencies impacted the pricing of securities backed by subprime assets. Spreads widened again as institutions were forced to sell downgraded securities.

Share markets followed a similar path. After an initial bout of enthusiasm following the Fed rate cuts, equities struggled through the final quarter of the year, weighed down by losses in the financial sector and poor third quarter profit results in the US. Listed companies reported lower earnings following 20 consecutive quarters of strong profit growth.

The catalyst for this turmoil has been a sharp deterioration in delinquencies on subprime mortgages in the United States. Subprime borrowers are lenders who cannot qualify for prime financing due to low credit scores and an inability to document income and assets.

In simple terms, 7 million Americans with little or no money have been extended finance on favourable terms, allowing them to borrow close to the full value of their homes during a housing bubble that peaked in 2006. With housing values now falling precipitously,

1.5 million of these mortgagees will likely default and most will lose their homes. Unlike the US, non-conforming loans in Australia (the closest we have to subprime) represent only 1% of outstanding loans and 90 day arrears on these loans are much lower at 7%.



In Australia, the vast majority of mortgages are originated and held on the balance sheets of the major commercial banks. In the US, mortgages are generally pooled together outside the banking system and securitised into investment instruments called Asset Backed Securities. These bonds are in turn sold to a broad range of investment institutions.

## Asset Backed Securities (ABS)

Asset securitisation occurs when a pool of illiquid assets, such as residential and commercial mortgages are bundled together into tradeable bonds that are sold to fixed interest investors. Residential Mortgage Backed Securities (RMBS) are the primary instrument for bundling residential mortgages. The lender or loan originator sells a portfolio of loans into a trust structure or special purpose vehicle (SPV) that is held off balance sheet. The SPV is typically funded by a credit line provided by one of the commercial banks through a 'conduit' or 'warehouse' facility.

All RMBS benefit from some form of credit enhancement which is used to raise the credit rating of the ABS so it can be sold as an investment grade

bond. The most common form of enhancement comes from splitting the asset-backed security into senior and subordinated tranches based on the quality of the underlying mortgages (prime, Alt-A, subprime). The senior tranches are AAA rated ensuring interest from institutional investors.

Subprime ABS (lower tranches) issued in the US were purchased by all manner of investment institutions around the globe. To complicate matters further, another class of investment bonds called CDO's, backed by a portfolio of RMBS as collateral, have been popular with hedge funds and institutions in recent years. Over 50% of the \$US500 billion in CDO's issued since 2000 were backed by subprime MBS.

The emergence of structured credit and risk transfer markets has been an important feature of the disintermediation of the banking system that has occurred in recent years. Australia has also participated in the development of these markets. ABS have provided a source of wholesale funding for non-bank financial institutions such as Aussie Home Loans and RAMS.

This has allowed these non-bank originators to compete with the major banks on equal terms. It has also allowed larger Australian companies to directly access competitive funding internationally bypassing their traditional banking relationships. Centro Property Group recently got into trouble because it was relying on liquidity in the Commercial Mortgage Backed Security (CMBS) market to refinance bridging facilities drawn for the Heritage and New Deal acquisitions.

### How did the subprime disaster occur?

As with many other asset classes, low interest rates pushed home prices higher, making mortgage lending a very profitable business for everyone concerned. The problem was that no one expected prices to fall with valuation models assuming a 'soft landing' scenario for property.

As most of the mortgage originators in the US are not commercial banks, the industry is largely unregulated. While the mortgage originators were closest to the borrower, they had no ongoing exposure to the performance of the loans once the mortgages were securitised and the bonds were sold.

With little 'skin in the game' in the event of losses, many of these originators adopted appalling lending practices. At the peak 38% of subprime lenders made no deposit, 43% provided no proof of income; and 80% of these loans offered 'teaser' rates which increased significantly two and three years into the loan.

In the aftermath of the dot-com boom, regulators introduced legislation requiring retirement funds to better match their longer term assets and liabilities. Where equities had failed to do this, the demand for investment grade bonds crafted from low-quality mortgages sky rocketed. There was such an appetite for bonds backed by these pooled mortgages that almost anyone could access funding.

The credit risk was borne by the bond holders in the ABS and CDO's, as well as the banks that had taken these securities as collateral. Many of these 'sophisticated investors' in hindsight were too reliant on the ratings provided by agencies such as Moody's and Standard & Poors. In the end 80 cents in every dollar of subprime debt ended up as AAA-rated paper.

The rating agencies made a critical error in assuming portfolios of lower rated bonds from various securitisation pools would not be correlated (much as they assume portfolios from different industries are not correlated). Because in many cases the agencies were assigning AAA ratings to bonds using BBB subprime MBS, investors loved the alchemy offered by lower apparent risk and higher returns.

### Contagion effect on debt markets

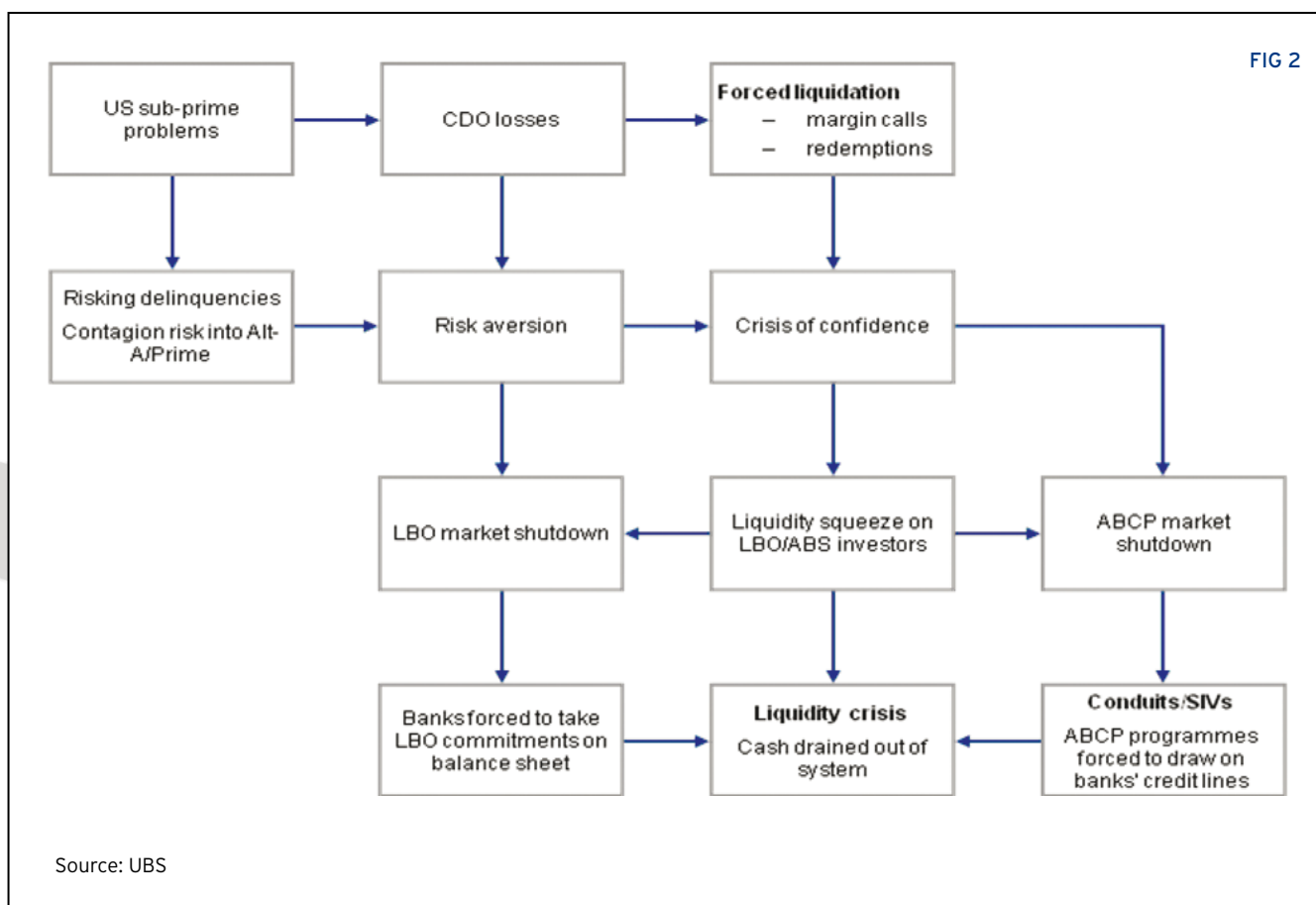
Subprime and ALT-A mortgages (similar to low doc loans in Australia) are a relatively small segment of debt markets, accounting for 3.6% of global debt securities outstanding. As the scale of the breakdown in lending practices; the failure of credit ratings; and

the mispricing of risk in this relatively small segment became evident, risk spreads and underwriting standards in other debt markets increased considerably.

New issuance of Asset Backed Commercial Paper (ABCP), the primary source of funding securitisation pools, has collapsed. This has in turn impacted liquidity in the broader commercial paper markets, an essential source of working capital funding for larger companies.

The frenetic level of Leverage Buyout activity in recent years has left the banks sitting on a backlog of \$245 billion in leverage loans. They cannot refinance these loans and get them off their books as investor interest has all but dried up. We are yet to see large impairment charges against these loans but are sure to see them reported with full year results in January.

Figure 2 outlines how losses in subprime lending have impacted other credit markets leading to a liquidity crisis in the banking system.

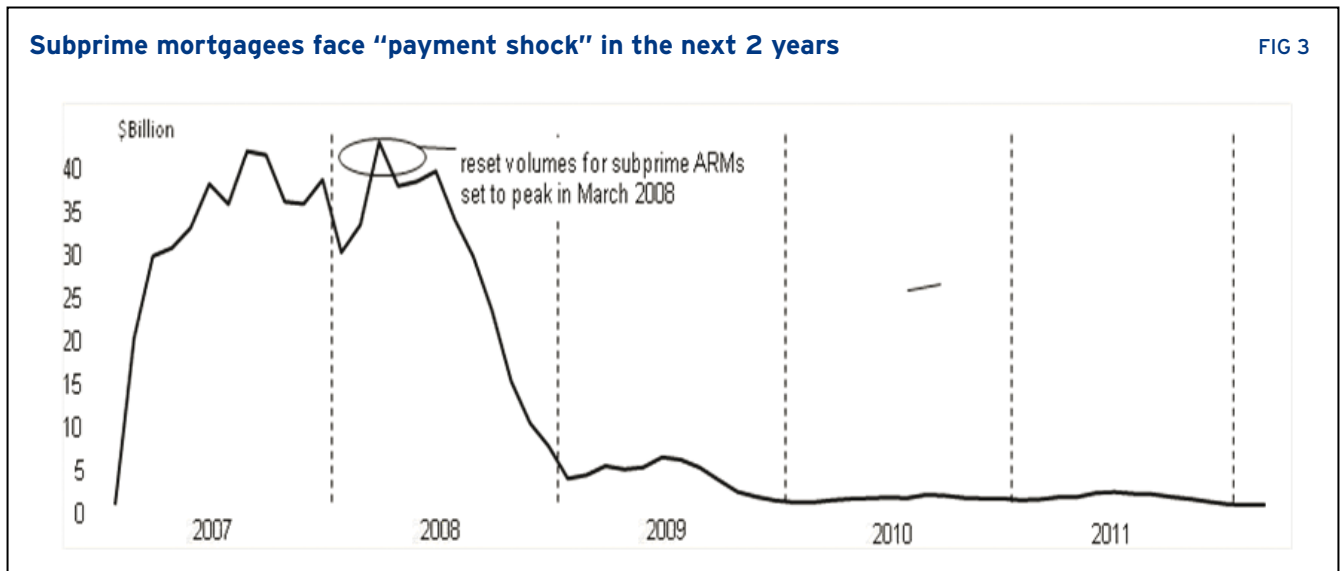


## Subprime losses will get a lot worse before they get better

With so many of the subprime loans written on 'honeymoon' interest rates for the first two years, the real crisis lies ahead as \$US 400 billion of adjustable rate mortgages (ARMs) are to reset at interest rates up to 40% higher in coming years.

resets is much higher. As these mortgages are not due to reset for a couple of years, delinquencies will not peak for some time.

Morgan Stanley completed some work looking at the equity that borrowers who took out ARMs in 2004-06 had in their properties at the end of 2006. If as expected prices correct by 15% from the



Delinquencies will increase significantly as resets continue. This is an ongoing problem. Research has shown that default rates are actually more sensitive to property values falling than to actual resets. This is a concern as most of the negative price adjustment is still ahead of us. Nationwide prices are expected to fall by at least a further 10% in 2008.

While prices were rising, subprime lenders when faced with resets would simply refinance. They don't have this option as prices fall and as lending standards have tightened, refinancing has become much tougher. As property prices fall delinquencies are due to accelerate as homeowners are faced with much higher interest rates and negative equity in their homes. The losses on structured investments will blow out as well as lower tranches are very sensitive to asset prices.

Finally, delinquencies and losses will be much higher on the most recent pools (2007) as these were written at the top of the cycle so the prospect of these homeowners having negative equity when the loan

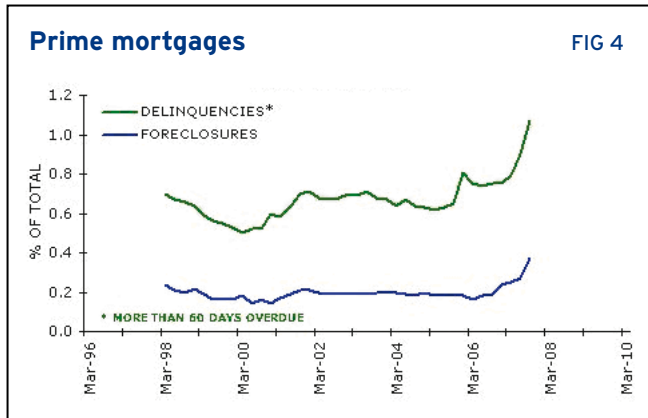
peak, 60% of homeowners who took on mortgages between 2004-2006 will have negative equity in their homes.

There is currently a four month supply of new homes that have never been lived in sitting on the market for sale. With committed buyers looking at negative equity from possession, many are simply posting the keys back and defaulting. In states like California there is no recourse to personal assets, so borrowers have little disincentive to default.

While subprime and Alt-A lenders represent only 22% of outstanding mortgages, they have been the marginal buyers in recent years accounting for 40% of homes sold in 2006. These home owners will quickly become marginal sellers given the prospect of resets they can't afford and ultimately distressed sellers in the hands of the lender's upon foreclosure.

A particular concern is the deterioration we are starting to see in delinquencies on prime mortgages.

Prime lenders who are forced to sell for all the normal reasons (ill health, loss of employment etc) simply cannot sell their properties with so much stock on the market.



If we do move into a protracted recession with sizable job losses then delinquencies will spread more broadly to higher quality credits and will be an order of magnitude higher.

Bill Goss, Head of PIMCO, the largest bond manager in the US put it nicely:

*“Credit contraction, with its inevitable companion of asset destruction, is spreading with the speed of an infectious bacterial disease.”*

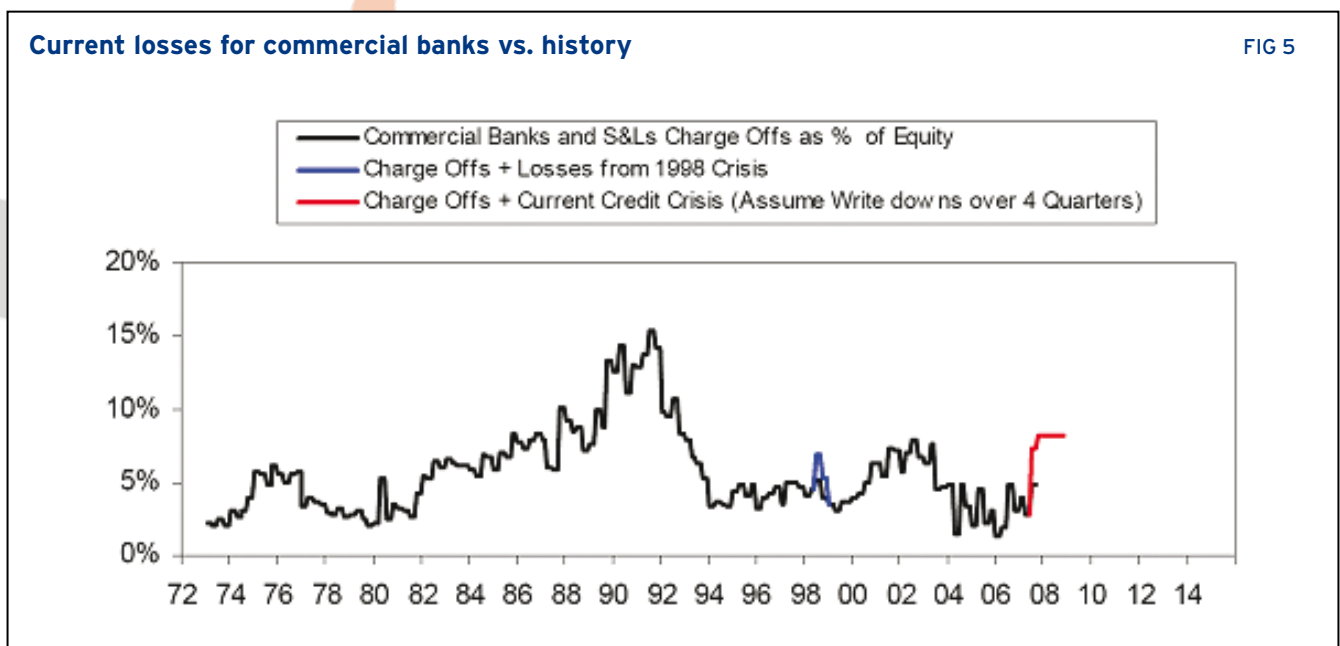
## The size of the losses in perspective

In assessing the impact of the current turmoil on economic activity and asset markets, we have to dimension the size of losses to be incurred by the banking system and consider the impact such losses are likely to have on credit conditions going forward.

There is a great deal of uncertainty as to the size of the losses due to the opacity of pricing these structured investments. Some of the bonds are priced to market (what the bonds actually trade at, if they trade at all); some are priced to 'model' based on underlying assumptions, most of which are flawed; and some are valued on underlying cash flows as they are realised.

The exposure of financial institutions is not well understood either, as many of these securities are held off balance sheet or as collateral against loans to investment funds.

Consultancy group Bridgewater are at the higher end of the range of projected losses. They estimate the total losses on subprime-related loans will end up being around US\$390 billion, with 23% of the value of subprime mortgages written off over time. In addition a further US\$400 billion is estimated to be lost on corporate liabilities as a result of the credit crunch. This includes everything from leveraged deals that fall over, to high yield credits and commercial real estate



backed by ABS. The Commercial and Investment Banks will bear the brunt of the losses at \$370 billion. While these numbers are large it represents less than 1% of assets held by these entities (see Figure 5 on previous page).

Putting these losses in perspective, the expected write-offs incurred by the banking system will be of a similar scale to the corporate losses of the last recession (US), the 1998 credit crisis and the Latin American debt crisis, but well below the Savings and Loan crisis of the late 1980's.

### Banks are at the centre of this crisis

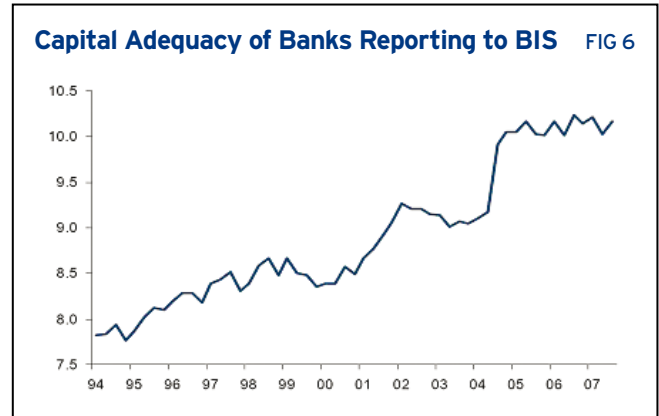
As the primary source of liquidity to financial markets, the commercial banks have found themselves at the centre of this crisis. The banks were happy to participate in the emergence of structured product markets, as it allowed them to finance loans off balance sheet providing advantages in terms of both regulatory capital and funding costs.

With structured credit markets closing up, many of these off balance sheet vehicles are now calling on backup lines of credit provided by the banks. These funding commitments have forced the banks to bring these structures back onto their own balance sheets at a time when they are booking sizeable losses. This is putting pressure on their capital adequacy as shareholder's equity is getting hit by losses at a time when balance sheets are growing involuntarily as backstop facilities are called upon.

Banks are thinly capitalised businesses. Australian banks by way of example have gross loans and advances of \$1.5 trillion supported by just \$129 billion of shareholder's equity. Under the Basel Accord regulators the world over have set minimum capital requirements for banking institutions to ensure they are adequately capitalised. Australian banks are required to maintain a risk-based capital ratio of 8% of risk weighted assets at all times. As at June 2007 the industry was well covered at 10%.

Some comfort is gained from the fact that globally those banks that report to the Bank for International Settlement

(BIS) are in much better shape to weather the current quandary than was the case during the Latin American debt crisis or the Savings and Loan crisis in the late 1980's.



Mr Malcolm D Knight, General Manager of the BIS summed up the current situation in the bank's latest quarterly report:

*"The banks are now faced with the prospect of a substantial, involuntary and uncertain increase in their balance sheets. While many banks have reasonable capital cushions, this could significantly tighten the flow of credit to the productive sector. And this uncertainty creates a considerable downside risk to the macroeconomy."*

Conventional wisdom would have it that asset securitisation and the growth of credit risk transfer markets has enhanced the stability of the financial system by allowing a wider dispersion of credit risk. Recent events have demonstrated that with the closing of structured debt markets, the commercial and central banks are still the primary source of liquidity. So while risk may have been more broadly dispersed, liquidity has not really been enhanced and the complexity of these financial instruments has greatly increased uncertainty.

As a consequence of these trends: Large losses, involuntary balance sheet growth, and opacity around counterparty risks. The banks are reluctant to lend, they are withdrawing credit where they can and maximising short-term liquidity. The overall result, liquidity crisis.

## Central bank action

Central banks have acted decisively by providing funding on favourable terms to relieve this stress as commercial banks continue to hoard cash and maximise liquidity.

In late December, the ECB unexpectedly provided funding to authorised deposit taking institutions at rates well below the prevailing market rate. Euro area banks bid for a huge Euro 348.6 billion in late December. In addition, the Fed announced that it would continue to conduct term auction facilities on favourable terms for "as long as necessary."

## When will the environment improve?

Visibility will inevitably improve and confidence will be restored as banks and investment institutions report more losses and as the recapitalisation of the bank's capital base continues.

If the losses are consistent with those nominated above (given the banks are starting from a strong capital position and the charge-offs are in line with previous experience), the issue for financial markets becomes a matter of timing - how quickly losses are reported and how quickly the banks raise equity and recapitalise.

Financial institutions to date have only reported a fraction of the losses estimated above. The full year audited bank results which will be released through January are the next major hurdle for capital markets.

So far close to \$50 billion in new capital has been injected in the global banks, mainly from sovereign wealth funds. In the past few months we have seen China Investment Corporation inject \$5 billion into Morgan Stanley, Citigroup received \$7.5 billion in capital from the Abu Dhabi Investment Authority and UBS received \$10 billion from the Government of Singapore Investment Corp. Merrill Lynch said in late December it will raise up to \$6.2 billion from Temasek.

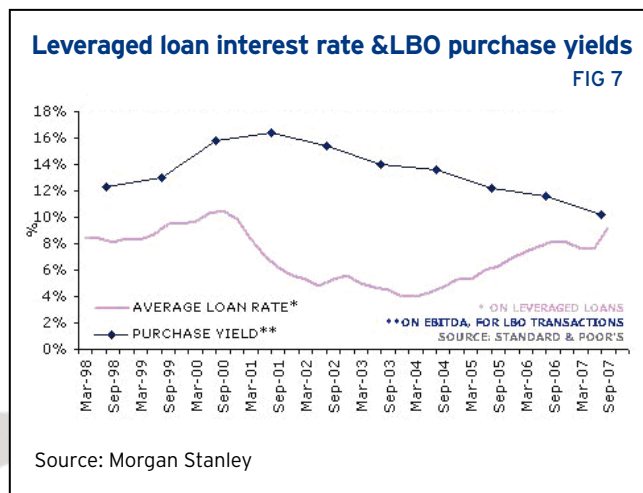
When we think about the size of the losses still to be reported in coming periods and the surplus capital in existing balance sheets, the banks have probably raised only half of what they need to.

## Implications for asset pricing

This crisis has effected every lending segment, with spreads on commercial paper, term funding and corporate bonds all increasing significantly. As with any credit crisis the outcome will be the same. With financial institutions having lost between \$300-\$400 billion in capital, credit conditions will be tight for some time as these institutions rebuild their capital base.

The implications for asset pricing and equity markets are significant. The days of cheap money pushing asset prices higher are over. In hindsight, the beginning of 2007 will mark the turning point in a reflation cycle that started back in 2002, where the cost of credit bottomed and asset prices (as measured by yields) peaked.

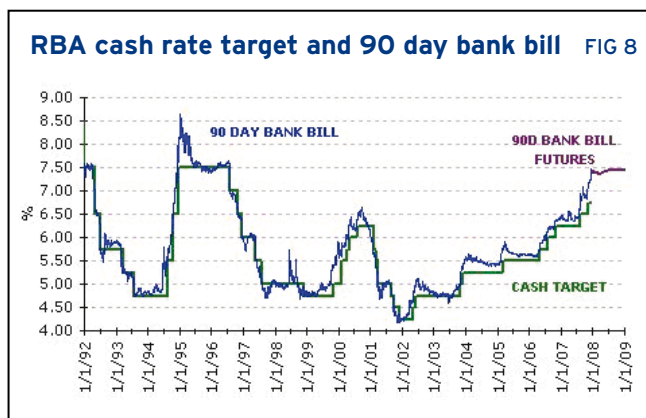
Nowhere has this trend been more evident than the LBO boom of recent years. With prices having risen from years of cheap money pushing valuations higher and now with funding costs increasing, this debt-driven arbitrage has closed (Figure 7). With credit being rationed and the banks awash with dead deals, bankers will be reluctant to finance these transactions. The days of corporate raiders launching hostile bids for the likes of Qantas and Cole Group are for the time being over.



Tighter credit conditions are a headwind for the real economy as well. For years equity withdrawal has been an import source of funding for excessive household spending both in the US and in Australia.

Tighter credit conditions will ensure households look to deleverage and reduce spending. The recent rate increases from commercial banks was the first in a decade in the absence of an official increase from the Reserve Bank.

Figure 8 reveals the gap between the RBA official target cash rate and the 90 day bank bill rate which banks borrow at. With bank bills at 7.5% this is the tightest credit environment we have seen in 12 years and will inevitably impact economic activity. Given this, it is unlikely the Reserve Bank will have to push rates much higher in the absence of higher core inflation.



### Will the US move into recession?

If the US economy sinks into recession, this will be the first consumer-lead recession in 18 years. The 2001 recession was a profit-lead recession, a hangover from the excesses of the dot-com boom of the late 1990's when companies had over-invested in capital and people. The subsequent bust and profit collapse resulted in a steep decline in business investment and massive layoffs. Job losses eventually fed through to softer private consumption and recession.

The story behind the current environment, is the precarious state of US households who have spent

beyond their means for years and who are now faced with a sharp contraction in net worth at a time when personal finances are stretched.

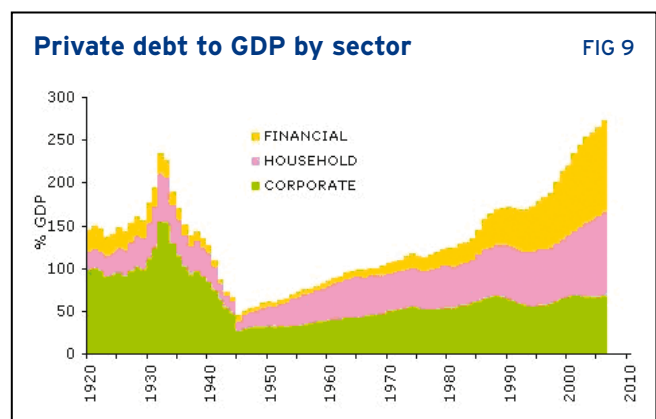
The housing boom provided a source of supplementary income for consumers who refinanced and withdrew equity from their homes. Others simply spent more as housing values soared. This cycle is now reversing as prices fall and households look to deleverage. The only way they can do this is by curtailing spending.

Morgan Stanley Economist Stephen Roach put it succinctly

*“The American economy is slipping into its second post-bubble recession in seven years. Just as the bursting of the dot-com bubble led to a downturn in 2001 and '02, the simultaneous popping of the housing and credit bubbles is doing the same right now.”*

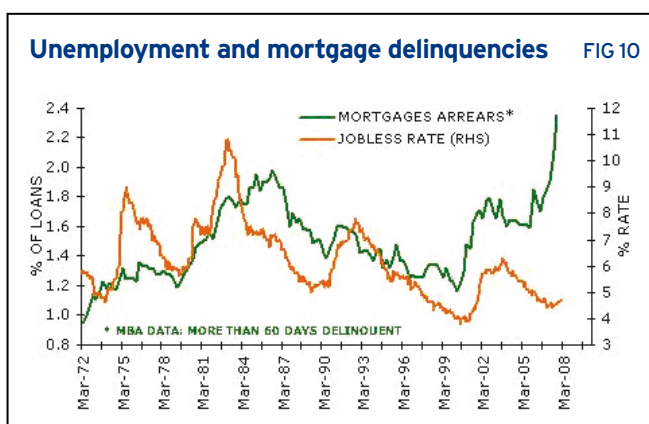
According to Federal Reserve figures, private real estate represents approximately one third of household assets..Home owner's equity is a little over half of this with mortgages accounting for the balance. With housing values expected to decline by 15 to 20% from the peak, housing equity is due to decline by 25 to 30%.

This is a significant hit to net worth, similar in magnitude to the equities bust of the late 1990s, it will inevitably have a meaningful impact on private spending in the economy. The correction in equity markets has further exacerbated this loss of net worth.



Based on prior experience, many commentators are downplaying the likely impact this will have on consumer spending behaviour. However, the impact this time around is likely to be far more significant given the transformation of household balance sheets in recent years.

Private sector leverage now exceeds the peak in the Great Depression, except this time the excess lies with households, not corporates (Figure 9). The leverage will only exaggerate the impact on underlying spending behaviour from falling asset values as households look to reduce debt.



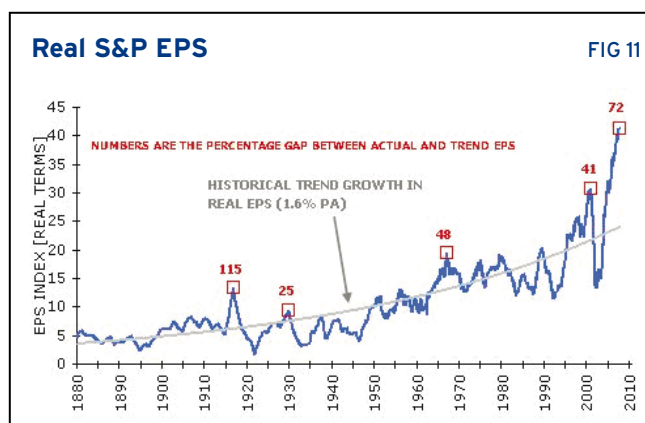
Of particular concern is the unprecedented level of credit stress in the absence of the usual triggers - higher interest rates (average rates are still at cycle lows even though Fed has increased official cash rates) and rising unemployment. **Households simply have too much debt.** Housing stress as measured by mortgage arrears is at record levels and the economy hasn't really slowed down yet! If recession hits and employment conditions deteriorate the downturn could be deeper and more protracted than many expect as households rebuild their financial standing.

### Outlook for US Equities

The US market does not look expensive based on projected earnings. The problem is earnings forecasts are way too high and do not yet reflect the weaker outlook.

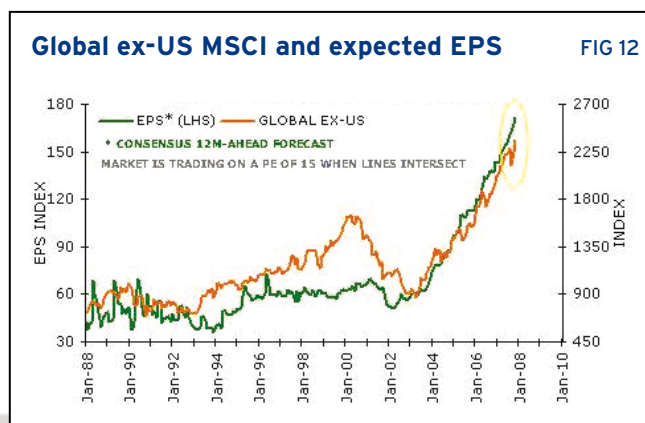
There are a number of concerns. Firstly, earnings for the S&P 500 companies have more than doubled in

recent years, leading many commentators to talk of an 'earnings bubble' in equity markets. Corporate earnings have increased so far above trend in fact (Figure 11) that one must question the sustainability of current inflated returns, particularly given the prospects of a deeper recession in 2008. With profits having risen so much, you wonder how far earnings may fall in a weaker environment.



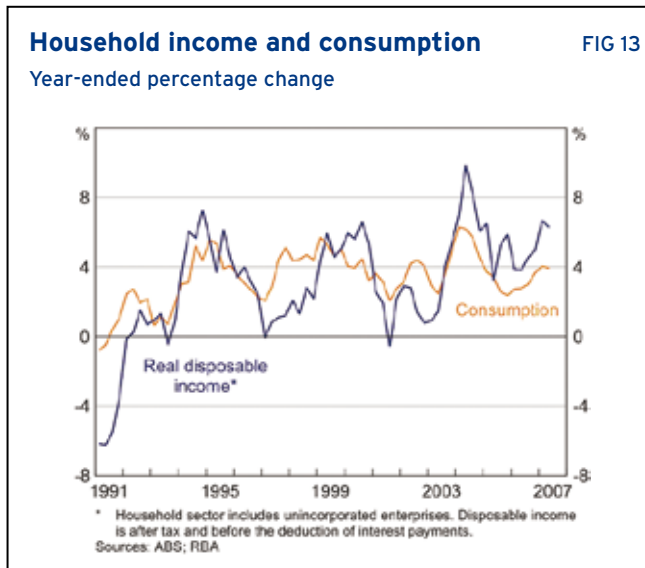
Secondly, earnings forecasts for 2008 are far too high, with analysts still looking for 10% earnings growth in the year ahead. While investors have started to factor in more realistic expectations given the recent market correction, it is difficult to see a scenario where US equities move high in the face of earnings disappointment. As one economist put it, "we are looking at a tsunami of downgrades in the year ahead."

When we look at equity markets outside the US the situation is much the same. In a weaker environment profits are clearly at risk. (Figure 12).



## The Australian Economy

The Australian economy continues to grow strongly. We are in the midst of the best period of household income growth in 20 years (Figure 13). Coupled with solid appreciation in household net wealth, the second half of 2007 witnessed a strong recovery in confidence and spending.



Business conditions reflect this robust domestic demand with corporate profit share now pushing a 30 year high. Companies have been reinvesting to participate in this growth with business investment increasing 10% in 2007 and business surveys suggesting this level of investment will continue in the medium term.

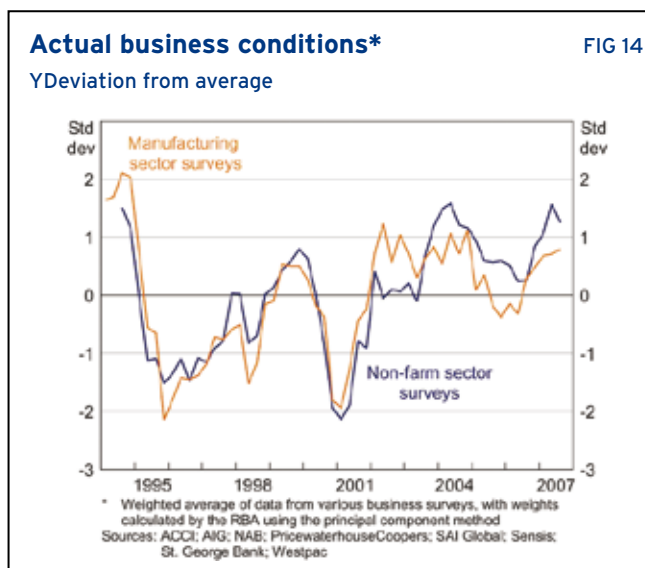


Figure 14 shows just how good business conditions have been in recent years, a favourable environment fully captured in higher corporate earnings and share prices.

The domestic economy will be supported in the medium term by ongoing strength in commodity markets, business investment and household spending. As our base case we would expect the Australian economy to grow modestly above trend in the next few years.

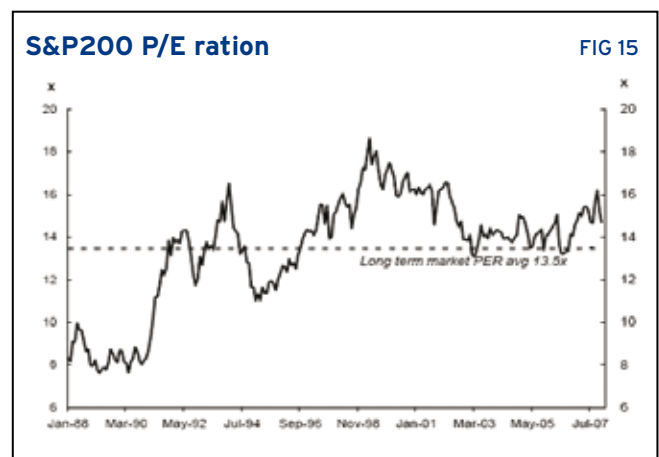
### Australian Equities

While the economic expansion should continue, corporate earnings growth in the financial year ahead is likely to be the softest in five years at around 7%. In the second half of last year profit forecasts fell sharply, lead by downgrades from property shares and the stronger Australian dollar. Reflecting these downgrades, industrial shares have fallen over the last six months and property trusts have fallen by more than 10%.

Ongoing pressure from the stronger Australian dollar, tight employment markets, and restrictive credit conditions will ensure interim results, due to be released in February, will be mixed at best.

Furthermore, given the uncertain environment, companies are likely to be cautious in their commentary on the outlook, providing little comfort for shareholders.

Valuations are looking more palatable following the recent correction, with equities now priced in line with historic averages.



## Portfolio Strategy

Last year can be broken down into two distinct periods: before and after the credit crisis. The first half of the year was dominated by a continuation of the same themes that have driven equity markets higher in recent years - ongoing strength in commodities and growth in emerging markets.

Energy and Resource shares outperformed with profit forecasts upgraded as high commodity prices stayed 'stronger for longer'. Associated industries such as mining services and contractors also benefited from the unprecedented project workload tied to the mining boom. Those domestic cyclicals leveraged to a recovery in household spending such as retailers also did particularly well.

On the other side of the ledger, with strong commodity prices and rising interest rates pushing the Australian dollar higher, profits of Australian exporters and industrial companies with international businesses have been under pressure. Shares in some of the leading International growth stocks struggled through this period, particularly those exposed to the US consumer.

These trends more or less persisted into year end with market leadership continuing to narrow around these key themes.

The credit crisis which engulfed the markets in the third quarter saw weaknesses in a number of sectors. In particular, those industries that were the hardest hit had benefited the most from easy credit conditions. The property trusts were singled out with 'cap rates' (the basis for independent valuations) having moved to unsustainable low levels. Those property trusts that had pushed offshore in pursuit of debt-driven growth fell sharply.

While the Australian investment banks do not have any material subprime exposure, they have been tarred with the same brush as their international peers. Tighter credit conditions and asset deflation will inevitably make business tougher for them going forward.

The trading banks have also been weak on margin concerns, with margins under pressure in the short term due to higher wholesale funding costs. We see this as an opportunity, with the longer term value of these businesses improving with the demise of non-bank financial institutions.

Finally, shares in companies that had taken advantage of low interest rates by financially engineered returns have also fallen. The heavily geared infrastructure sector which has employed some of the most creative financial structures imaginable, has performed poorly. Many of these vehicles are so heavily indebted they are borrowing money to cover their dividends. While funding costs are locked in on existing projects, debt-funded growth becomes far more challenging in this new environment.

As is always the case in the final stages of a bull market, the end will be marked by capitulation in those key themes that have supported the bull market in recent years. With global growth slowing and valuations somewhat stretched we have reduced our exposure to resources while retaining positions in Rio Tinto and BHP Billiton.

As the current cycle matures we need to be wary of backing yesterday's themes. Instead we should look to invest in sectors that have struggled through this recent cycle. We have added a number of agricultural names to the portfolio (AWB, Australian Barley Board, and Select Harvest). These companies have suffered with the drought which looks on the cusp of breaking, and can be purchased around book value reflecting the poor returns in recent years.

We also invested in some of the building material companies that have struggled with weaker building activity in NSW and Victoria, and the strong Australian dollar (Boral and Gunns).

The Australian dollar is first and foremost a commodity currency, further supported by high interest rates here in Australia. In the medium term, the currency may well have peaked as commodity prices will probably trend lower with softer global growth. As financial conditions are currently as tight as they have been in 12 years we cannot see the case for pushing interest rates much higher. On this basis those international growth stocks

that have underperformed with the headwind of a stronger Australian dollar should do better in the period ahead. Accordingly, we have added to the fund's holdings in NewsCorp, Computershare, Aristocrat and Henderson.

### In summary

The direction of international markets will enviably take their lead from the US, particularly given the current uncertain environment. The US market is likely to struggle through most of 2008, weighed down by weak economic data, profit downgrades and restrictive credit conditions.

As Australian shares have been re-rated in recent years, it is hard to see domestic equities continuing to outperform in spite of the solid underlying fundamentals. On this basis we would expect the local market to consolidate at current levels and deliver, at best, modest returns for the year ahead.

While the environment looks particularly challenging, equity markets are starting to reflect this. When we look at the portfolio, we are encouraged by the value embedded in key positions. This is not to say the market cannot move lower, but the bad news from subprime and softer growth is increasingly being priced into asset values.

What is not yet priced into asset markets but will emerge as a risk moving forward, is the prospect of a prolonged downturn in US activity which inevitably would be matched by much broader credit losses. Much will depend on how well global growth holds up without the support of US consumers, a key source of incremental demand in this recent cycle. ■

**Justin Braiting**  
CHIEF INVESTMENT OFFICER

### PORTFOLIO PERFORMANCE

Gross Performance	1 month	3 month	6 month	Financial YTD 07
Wilson Leaders Ltd	-1.63%	-0.55%	5.77%	5.77%
All Ords Accum	-2.36%	0.85%	3.66%	3.66%
Relative Performance	0.73%	-1.39%	2.11%	2.11%

### PORTFOLIO STRUCTURE

Investment Type	As at 30 November 2007		As at 31 December 2007	
	\$m	%	\$m	% of net assets
Listed Securities	131.94	120.80%	136.30	128.9%
Fixed interest and Cash	2.32	2.10%	3.37	3.2%
<b>Gross Assets</b>	<b>134.26</b>	<b>122.90%</b>	<b>139.67</b>	<b>132.1%</b>
Short positions	-25.03	-22.90%	-33.94	-32.1%

The listed securities portfolio is detailed on the following page.

As at 31 December 2007 the equity portfolio gave exposure to:

<b>Consumer Discretionary</b>			<b>Industrials</b>		
A.B.C. Learning Centres Ltd.	3,263,400	2.39%	Toll Holdings Ltd.	1,717,500	1.26%
Amalgamated Holdings Ltd.	1,442,785	1.06%		<b>1,717,500</b>	<b>1.26%</b>
APN News & Media Ltd.	3,510,695	2.58%	<b>Information Technology</b>		
Austar United Communications Ltd.	982,700	0.72%	Computershare Ltd.	2,173,600	1.59%
Consolidated Media Holdings Ltd.	840,000	0.62%	Reckon Ltd.	1,247,286	0.92%
Mitchell Communication Group Ltd.	412,560	0.30%		<b>3,420,886</b>	<b>2.51%</b>
News Corp.	7,812,450	5.73%	<b>Materials</b>		
Tatts Group Ltd.	1,596,000	1.17%	Boral Ltd.	1,224,000	0.90%
Village Roadshow Ltd Prf A	3,325,027	2.44%	Gunns Ltd.	1,456,000	1.07%
Webjet Ltd.	2,850,733	2.09%	James Hardie Industries N.V.	322,500	0.24%
	<b>26,036,350</b>	<b>19.10%</b>	PaperlinX Ltd.	1,064,000	0.78%
<b>Consumer Staples</b>				<b>4,066,500</b>	<b>2.99%</b>
ABB Grain Ltd.	2,940,600	2.16%	<b>Resources</b>		
AWB Ltd.	3,516,000	2.58%	Alumina Ltd.	2,993,900	2.20%
Metcash Ltd.	870,000	0.64%	BHP Billiton Ltd.	8,630,100	6.32%
Select Harvests Ltd.	2,796,406	2.05%	Rio Tinto Ltd.	4,295,910	3.15%
	<b>10,123,006</b>	<b>7.43%</b>		<b>15,919,910</b>	<b>11.67%</b>
<b>Property</b>			<b>Energy</b>		
Lend Lease Corp. Ltd.	3,806,000	2.79%	Oil Search Ltd.	2,570,500	1.89%
Tishman Speyer Office Fund	3,164,262	2.32%	Roc Oil Co. Ltd.	3,729,788	2.73%
Westfield Group Australia	3,780,000	2.77%		<b>6,300,288</b>	<b>4.62%</b>
	<b>10,750,262</b>	<b>7.88%</b>	<b>Telecommunication Services</b>		
<b>Financials</b>			PIPE Networks Ltd.	999,688	0.73%
Australia & New Zealand Banking Group Ltd.	8,921,754	6.55%	Reverse Corp. Ltd.	2,128,464	1.56%
Babcock & Brown Ltd.	1,276,050	0.94%	Telecom Corp. of New Zealand Ltd.	1,930,000	1.42%
Henderson Group PLC	3,691,800	2.71%		<b>5,058,152</b>	<b>3.71%</b>
Macquarie Group Ltd.	3,810,000	2.80%	<b>Utilities</b>		
National Australia Bank Ltd.	10,127,721	7.42%	AGL Energy Ltd.	1,598,400	1.17%
RAMS Home Loans Group Ltd.	1,917,771	1.41%	ConnectEast Group	1,595,000	1.17%
St. George Bank Ltd.	2,653,560	1.95%		<b>3,193,400</b>	<b>2.34%</b>
Westpac Banking Corp.	5,501,329	4.04%			
	<b>37,899,985</b>	<b>27.82%</b>			
<b>Insurance</b>					
QBE Insurance Group Ltd.	8,335,000	6.12%			
	8,335,000	6.12%			
<b>Health Care</b>					
Primary Health Care Ltd.	1,487,500	1.09%			
Pharmaxis Ltd.	1,992,629	1.46%	<b>Long</b>	<b>136,301,368</b>	<b>100.00%</b>
	<b>3,480,129</b>	<b>2.55%</b>	<b>Short</b>	<b>-33,935,112</b>	



