AUSTRALIAN LEADERS FUND

The Leading Edge

QUARTERLY REPORT | **July 2008**

In this edition of The Leading Edge we consider the outlook for international equity markets in light of weaker global activity; consider the implications of higher inflation and tighter monetary conditions on the Australian economy; and review portfolio strategy in light of these developments.

In the second part of the report we revisit some of the differences between Australian Leaders and the more traditional funds in which you can invest. You will also find a detailed explanation of how the company funds its investment portfolio. In particular we focus on dispelling some of the myths around hedge funds and short selling.

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The global economy is at an important juncture. We are transitioning from a period of abundance to one of scarcity where capital, credit and basic staples will increasingly be rationed. The credit crisis has resulted in a loss of capital and a repricing of risk that will ensure credit conditions remain tight in the medium term. As supply is constrained we are competing for basic staples such as food and energy, manifesting in inflationary pressure that will inevitably stymie growth.

Growth in North America has clearly slowed well below trend. Whether the economy is in recession or not is a moot point. What we are faced with is a protracted period of softer activity in North America which will inevitably weigh on corporate profitability and equity markets.

Equities rallied through the second quarter as a chorus of banking executives indicated the worst of the credit crisis was behind them and the prospect of systemic failure in the banking system appeared to have passed with the bailout of Bear Stearns. The economic data was also stronger than expected. First quarter GDP figures indicated the US economy was still expanding, marginally supporting the bull's case that the recession bullet has been avoided.

As we moved into June however, Central Bank commentary in Europe and the US turned decidedly more hawkish. In response to deteriorating inflation trends central bankers shifted from growth support to inflation control. In just a few weeks we have seen a sharp turnaround in interest rate expectations, clearly indicating that the Fed has finished cutting rates.

FIG 1A **Tightening cycle began even before economy moved into recession!**

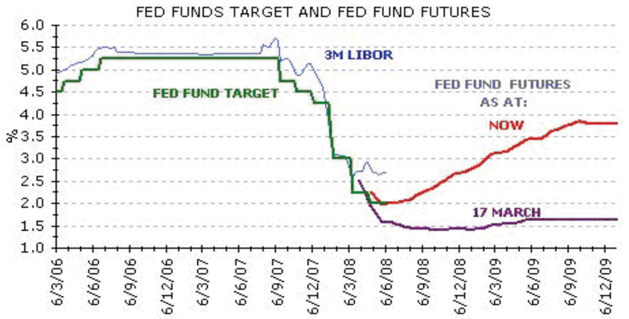
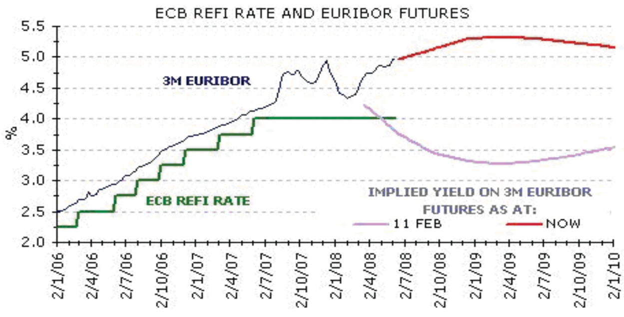


FIG 1B **Rate expectations in Europe have likewise been revised up**



Inflationary pressures fuelled by a weaker dollar and surging commodity prices have removed scope for the Fed to lower rates further which is bad news for equities as the economy slows.

While economic growth in the US was stronger than many expected in the first half, supported in part by $106 billion of fiscal stimulus, the second half of the year is going to be a lot tougher.

Even though the worst of the credit crisis may be behind us the economy is set for a protracted period of sub-economic growth. All the leading indicators support this emerging outcome (Fig 2a and 2B).

FIG 2A **Leading indicators point to a sharp contraction in activity**

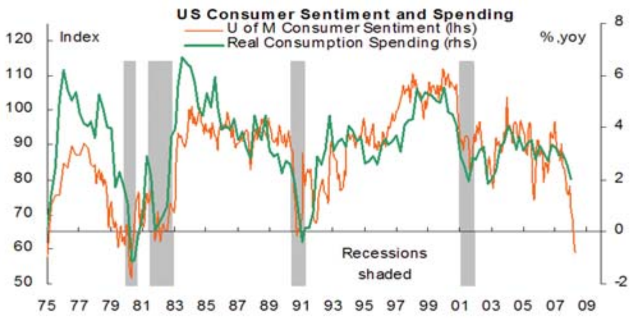
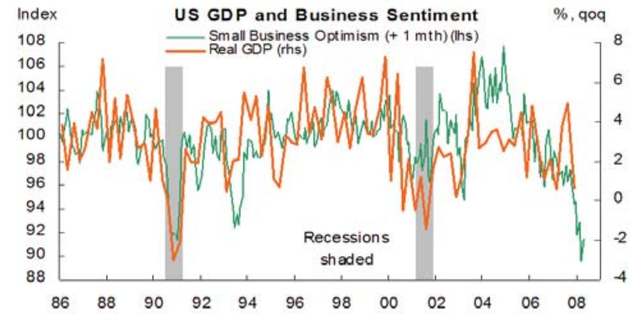


FIG 2B **Business confidence collapses also**



The bulls have remained sanguine with Q1'GDP coming in at 0.6%. However, if we look behind the headline numbers, real final domestic demand contracted (-0.4% at an annual rate) for the first time in 18 years with consumer spending on durable goods, housing, non-residential construction and business investment all contracting.

It is worth noting that consumers are notoriously slow to capitulate. Just look at New Zealand where financial conditions have been extremely tight for some time and the economy is now teetering on the precipice.

This will be the first consumer-led recession in the US for 18 years. Household spending accounts for roughly 70% of the $12 trillion US economy and is the backbone of economic activity. It is supported by three factors: income security; financial conditions and household wealth.

While the 2000-2001 recession was a 'profit-led' recession with companies savagely cutting back spending following the dot-com bust, this downturn will be very different. For years American households have been taking on ever increasing amounts of debt to support spending that has exceeded their income. As asset values have increased household wealth has supported this additional financial burden.

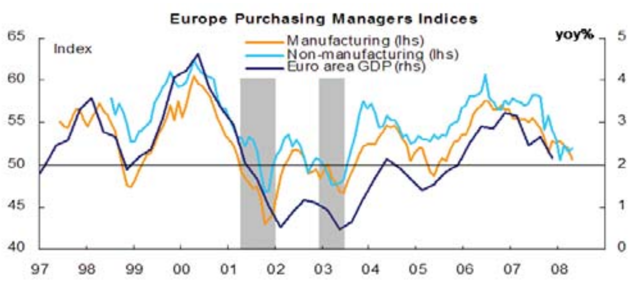
However the collapse in the housing market, the credit crisis and the associated fall in financial asset values has pushed net wealth sharply lower. Households will inevitably curtail spending and look to rebuild their financial standing. The spiralling cost of consumer staples such as food and energy will only put further pressure on household spending.

With greater integration of financial and product markets globally than ever before, the big unknown is the spill over of weaker activity in the US elsewhere. While the attraction of structured debt markets was the disbursement of risk away from any one institution, this has meant the loss of value on sub-prime assets in the US has become a global event.

Euro Centre banks have been amongst the worst hit. The UK as a financial centre looks like it will follow the US into recession. The collapse in the US dollar is putting enormous pressure on European exporters.

The downturn in North America, the weaker dollar and the credit crisis is clearly starting to impact trading conditions in other G7 regions (Fig 3a and 3b).

FIG 3A **Europe is clearly slowing**

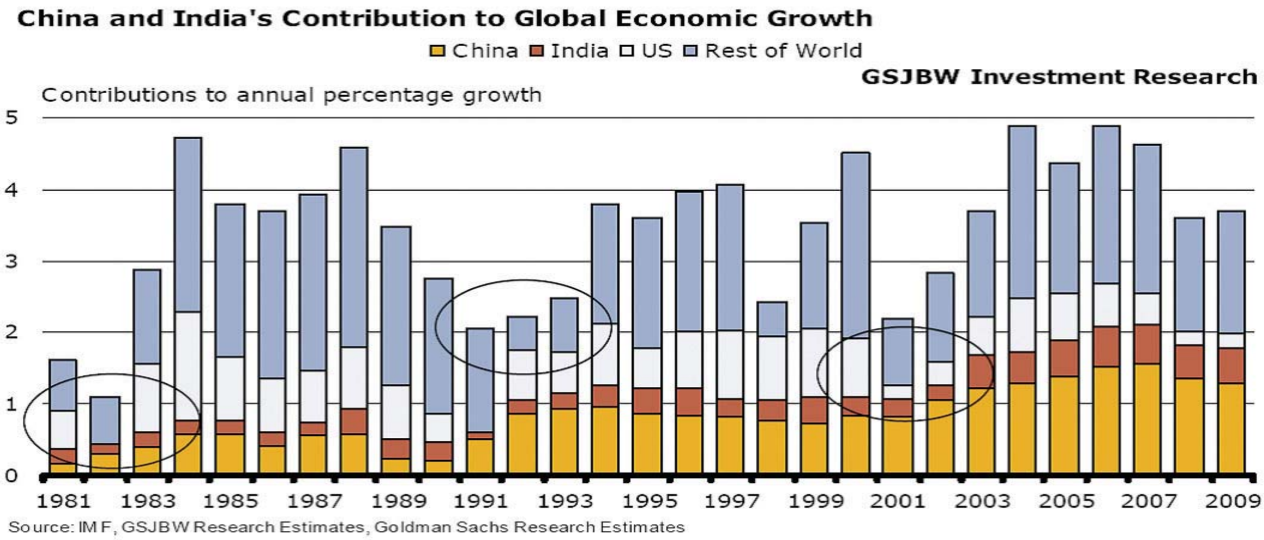


Source: Reuters, Bloomberg, Deutsche Bank AG estimates

FIG 3B **Strong Euro Likely to Slow Growth Further**

Source: Reuters, Bloomberg, Deutsche Bank AG estimates

FIG 4 **Composition of growth different this cycle**



The economic backdrop is even more downbeat in Japan than Western Europe. Falling real income growth and weaker external demand will ensure the Japanese economy contracts in the current quarter.

Unlike previous cycles where OECD nations dominated global growth, this cycle is different. Now we find the developing regions of China, India, and the FSU account for over half of the growth in global output (refer fig 4). While OECD growth will slow sharply, overall global growth will revert closer to trend.

The key unknown is the spill-over effect of weaker growth in OECD nations on those newly industrialising regions which are not completely immune.

While industrial production is holding up in China, exports (a key driver of growth this decade) are falling rapidly. We need to see the economy pivot with domestic consumption sustaining growth.

FIG 5A **As Exports slow Chinese domestic consumption will have to expand**

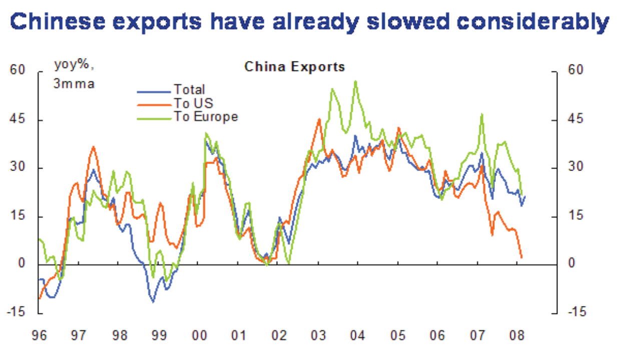
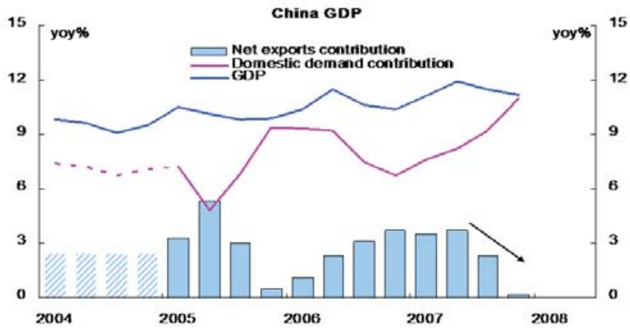


FIG 5B **Net exports have lately made little contribution to China's growth**



As many developing countries have tied their currencies to the US dollar they have inadvertently participated in the stimulus from lower interest rates and a weaker US dollar. A weaker currency fuels inflation as the value of imported goods increases. Coupled with escalating food and energy prices which are far more relevant to living costs in emerging markets, inflation has moved beyond 10% in over a dozen developing countries. With nominal interest rates below inflation in many of these countries including China, real interest rates are negative and highly stimulatory.

In the absence of any currency revaluation, interest rates in these countries must move much higher to combat inflation. This is a key risk to global growth and Australia in particular given our dependence on growth from these regions.

The outlook for corporate profits and equity markets

Given this economic climate, we expect to see corporate profit growth slow sharply in G7 countries.

FIG 6 **Corporate profits will fall more than expected**

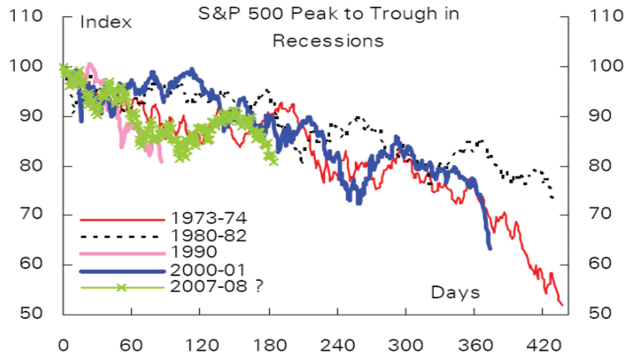
While international equities are attractively priced compared to historic experience (Fig 7), the profit expectations are still too high and markets are unlikely to sustain any sort of recovery until the depth and duration of the current downturn becomes clearer.

FIG 7 **International Equity Markets are Cheap**

Source: Reuters, Bloomberg, Deutsche Bank AG estimates

If we consider duration as an indicator of when markets may start to recover we are clearly still a long way out. Fig 8 shows the last five economic downturns. Our expectation is that this downturn is likely to last longer than most.

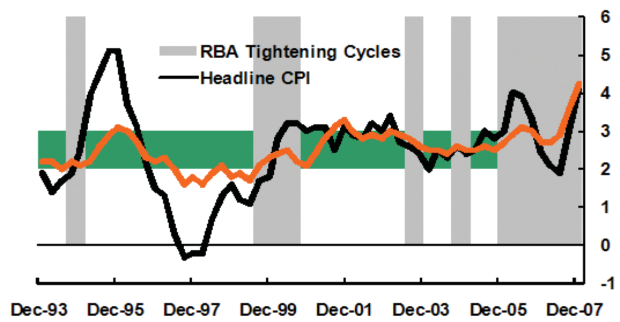
FIG 8 **Early Days in this Downturn**



Outlook for the Australian Economy

Activity levels in Australia are set to slow as the tightest financial conditions in a decade start to bite. Of particular concern for the Australian economy is the deteriorating inflation outlook and the prospect of further monetary tightening as the Reserve Bank moves to contain inflationary pressures in the economy. The reason we are so concerned with the inflation data is because we believe the inflationary pressures are structural in nature and may be persistent in the face of further policy action.

FIG 9 **Inflation is the Key Risk for the Australian Economy**



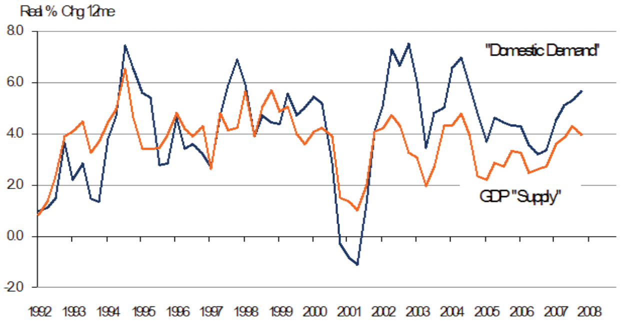
The clear mandate of the Central Bank is to contain inflation. The RBA's website states, "Policy decisions are made by the Reserve Bank Board, with the objective of achieving low and stable inflation over the medium term. Other major roles are maintaining financial system stability and promoting the safety and efficiency of the payments system."

We are concerned that with this clear mandate, the central bank will be forced to push interest rates even higher driving down household spending, to relieve demand pressures elsewhere in the economy.

Stepping back and looking at the source of pricing pressure in the economy we find a combination of structural and cyclical factors. After 18 years of growth the economy is fully employed and in some instances stretched to the limit. In any product market if resources are fully deployed prices rise to stymie incremental demand.

The Commodities boom and the lift in terms of trade has delivered an income shock to the economy estimated at 1.5% pa over the past four years. The productive capacity of the nation has not met this additional demand (Fig 10).

FIG 10 **Domestic demand continues to outstrip supply = rising inflation**



This additional call on the nation's productive capacity has left capital and labour markets fully employed.

FIG 11 **Capacity utilisation still well above trend**

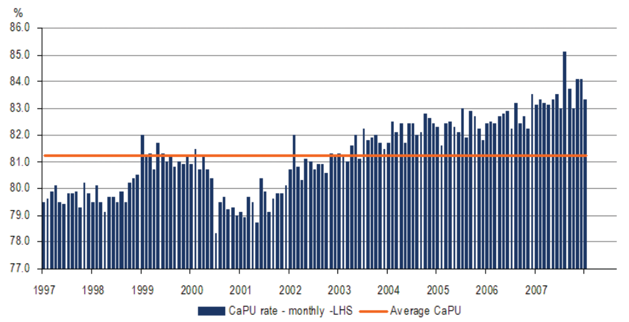
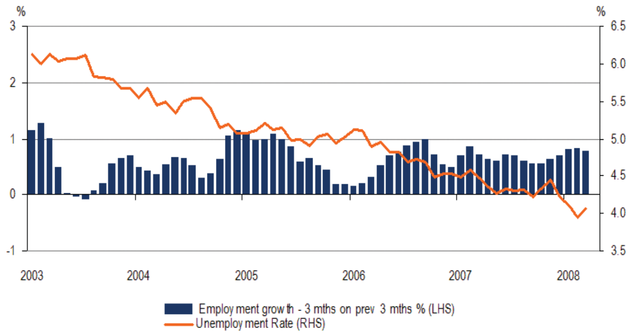


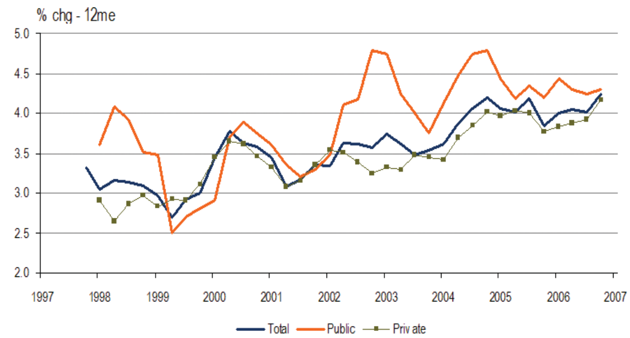
FIG 12 **The labour market continues to tighten**



Strength of demand is largely focused in those segments of the economy benefiting from the resource and infrastructure boom, yet the policy levers via interest rates are targeted at a different part of the economy (households).

The lift in demand for Australian product is structural and the industrialisation of Asian nations will not slow down in a hurry. Ultimately, higher interest rates won't deter the Chinese from demanding more of our minerals.

FIG 13 **Private sector wages trending higher**



Wages, the major factor cost of production for industry are a key source of inflationary pressure. For the last 20 years the wages share of income has been falling as the returns on capital have grown exponentially (Fig 14). While this can continue in an economy with spare capacity, as the labour market becomes fully employed the workforce is going to want its fare share. Inevitably this will put upward pressure on wages.

FIG 14 **Wages share of GDP to increase**

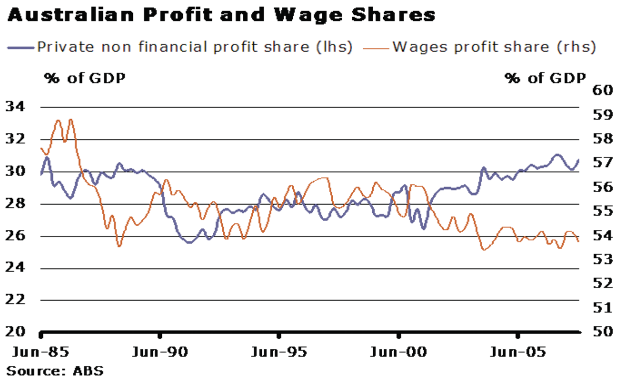
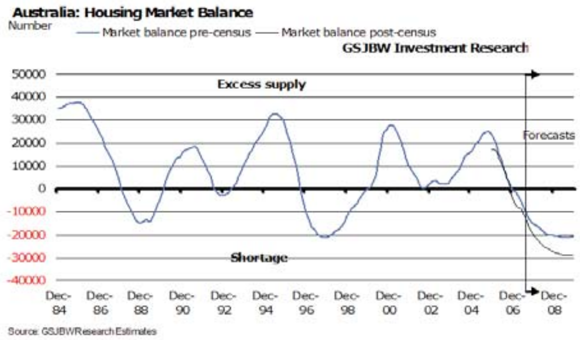
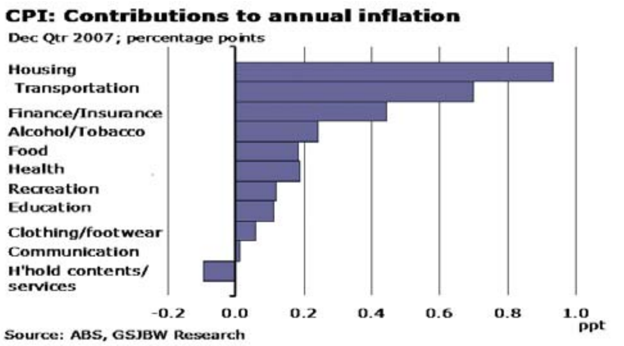


FIG 16 **Housing market structurally undersupplied**



A closer look at the components of the Consumer Price Index reveals structural issues at play in each of the major product markets. The fundamental theme is a shift from an environment of abundance to one of scarcity for basic staples such as energy, food, and accommodation. It is all going to cost a lot more. This has profound implications for inflation and growth.

FIG 15 **Inflation is Largely Structural**

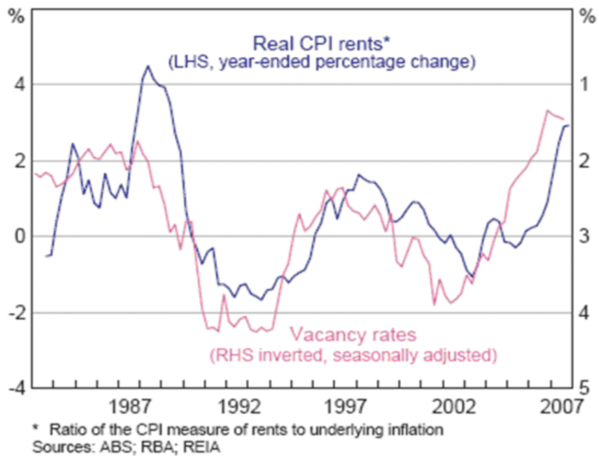


It is disturbing to find that in each of these product markets most issues are structural and unrelated to the strength of the economy (which higher interest rates will address).

Poor planning by state governments, particularly in New South Wales, has led to the worst housing shortage in 25 years. Household formation rates have lifted due to the strength in employment markets and high levels of immigration. Affordability is prohibitive and new homes are not being built fast enough to accommodate incremental demand (Fig 16).

Not surprisingly, this is feeding through to lower vacancy rates and higher rents which have increased by more than 10% in most capital cities (Fig 17). The shortage will continue until federal and state governments work together to address housing affordability.

FIG 17 **Vacancy Rates and Rents**



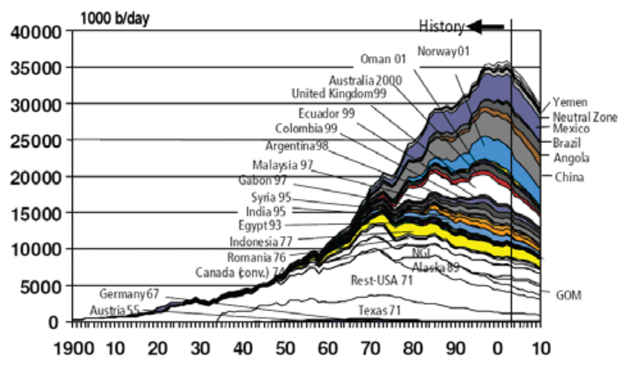
Turning to transportation costs, higher oil prices are here to stay and an energy crisis may well be looming. As supplier of last resort, OPEC has seen spare capacity diminished to just a few million barrels of daily production. Non-OPEC supply has consistently fallen short of expectations.

In spite of inflated prices, the reported reserves of the oil super majors show depletion consistently exceeding reserve additions. The reality of 'Peak Oil' may be fast approaching. American geologist M.K.Hubbert accurately forecast in 1955 that US oil production would peak in 1975 before commencing a steady decline. Using these same modelling techniques for key producing basins, many experts are suggesting we have reached peak production. In simple terms, as most of the large producing fields were discovered in the post-war period, these fields are maturing and as the reservoir pressure drops they are producing less. Recent discoveries are typically much smaller than the earlier discoveries and are not compensating sufficiently for the rate of decline in the more mature fields.

Since 1975 we have seen production peak in most traditional oil producing basins except of course the Middle East (Fig 18).

There are concerns production may now have peaked for the world's largest producer, Russia. Following 10 years of double digit growth where Russia accounted for half of incremental production, it now appears to have plateaued.

FIG 18 **Peak oil fast approaching**



Source: Industry database, 2003 (IHS 2003)
OGJ, 9 Feb 2004 (Jan-Nov 2003)

We are not running out of oil with conservative estimates of another 100 years of reserves in the ground. The issue is that production has plateaued at a time when China and India are increasing the demand for energy. The pricing mechanism will ultimately ration demand in the OECD as the demand from non-OECD countries grows.

As for food inflation, grain prices have shot through the roof. Less acreage is being planted for food as developing countries urbanise. Concurrently the demand for grain intensive protein increases with income in these countries.

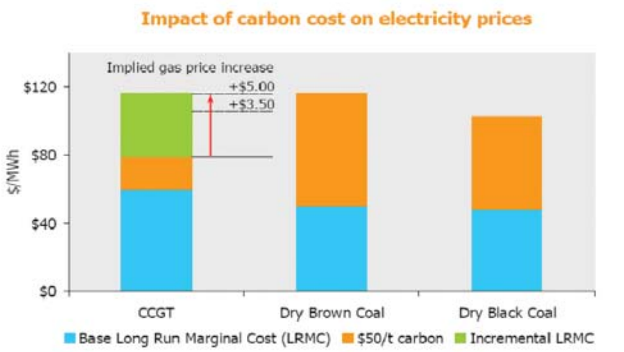
The production of alternate fuel sources such as biofuels is taking land away from food production. In the US this year 30% of the corn crop will be devoted to bio-fuel production. The International Energy Agency is forecasting that biofuels will account for 25% of non-OPEC supply growth in the medium term. Ethanol now accounts for 6% of the US gasoline pool and the US government is targeting 15 billion gallons of biofuel by 2015.

More broadly, there is pressure on the cost of all manner of utilities. Electricity prices have spiked due to underinvestment in generation capacity, aggravated by downtime from water restrictions and the drought.

Investment in new capacity is being deferred due to uncertainty around ownership of generation capacity in NSW and cost of carbon under the government's proposed emissions-trading scheme.

Fig 19 shows estimates from Santos of the incremental cost to coal and gas fired stations once a cap and trading regime is up and running in 2010. Carbon will double the unit operating costs of coal fired units which account for most of the national grid load. This price difference will have to be passed on to consumers one way or another.

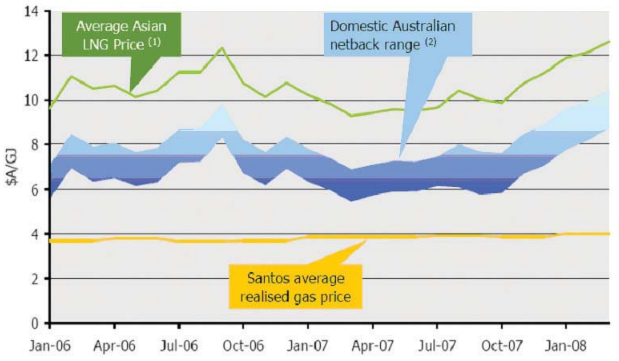
FIG 19 **Impact of carbon cost on electricity prices**



The graph demonstrates that for a combined cycle gas-fired station the carbon emitted is half that of coal, so all new base load capacity in a carbon constrained world is likely to consume gas as a fuel.

Australia has benefitted for years from cheap gas which at around $A3.50 per GJ at the well head, is half the Henry Hub price in the United States. As a stranded resource which can only be transported by pipeline, gas prices have remained extremely low in Australia by international standards. With over 20 million tonnes of coal seam methane based LNG facilities to be built on the East Coast of Australia, gas prices are likely to move over time toward oil parity (Fig 20).

FIG 20 **Prices available in domestic export markets**



In summary, there are numerous structural pressures that are pushing key factor costs higher for both industry and households. Tighter monetary policy targeted at slowing activity levels will be limited in addressing these pressures. A coordinated policy response to these challenging issues is required.

FIG 21 **The Big Squeeze**

Calculating Discretionary Cash Flow

Gross Disposable Income
less Employers social contributions
less Superannuation (employee contributions)
= **Disposable Cash Income**

plus 'Active' Mortgage Equity Withdrawal
plus Change in Personal Credit (less changes in margin lending)
= **Disposable Cash Flow**
less Interest expense
less Food expense
less Rent expense
less Operation of vehicles expense
less Electricity, gas and other fuel expense
less Health expense
less Insurance expense
= **Discretionary Cash Flow**

Source: GSJBW Research

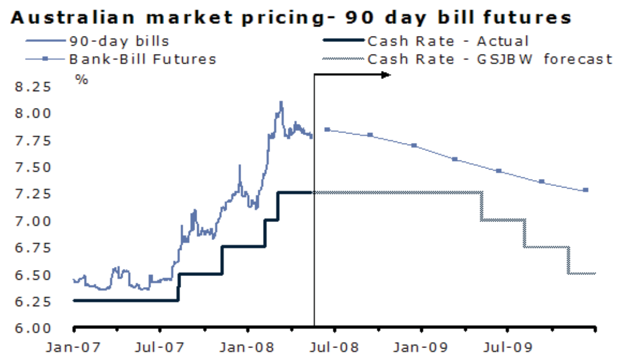
Close consideration of the income statement for a typical Australian household shows a rather ugly picture (Fig 21).

The big squeeze is an expense issue rather than a concern with wages and income security, although as the economy slows we could start to see layoffs in sectors exposed to softer consumer spending. The retail sector which is already showing considerable weakness, employs 19% of the workforce vs mining which employs just 1.3%.

In recent years on the back of surging asset markets, income has been supplemented with mortgage equity withdrawal and personal credit. With household net wealth now under pressure and banks tightening credit, this source of supplementary income will be far less prevalent.

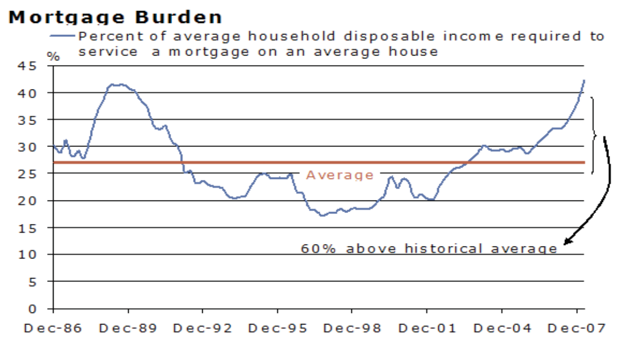
If we look at the major household expense items we find they are all shifting higher.

FIG 22A **Mortgage rates up by 25%**



Source: GSJBW Research Estimates, Iress

FIG 22B **Household balance sheets are overleveraged**



Source: GSJBW Research Estimates

Interest expense is clearly going higher and with household debt at record levels, the interest burden is much higher compared with the early 1990's (Fig 22B).

As discussed above, the cost of food, rent, fuel and energy are all moving higher leaving very little for discretionary cashflow.

As you may expect the big squeeze is having a real impact on sentiment and confidence (Fig 23A and 23B) - a precursor to a sharp contraction in household spending and economic growth.

FIG 23A **Confidence Measures have collapsed**

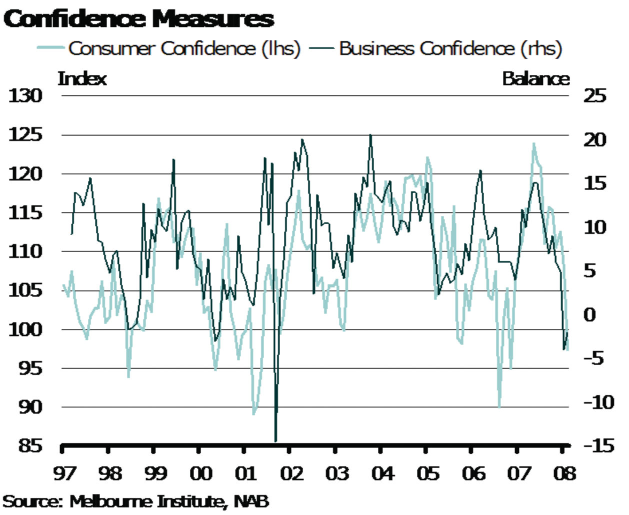
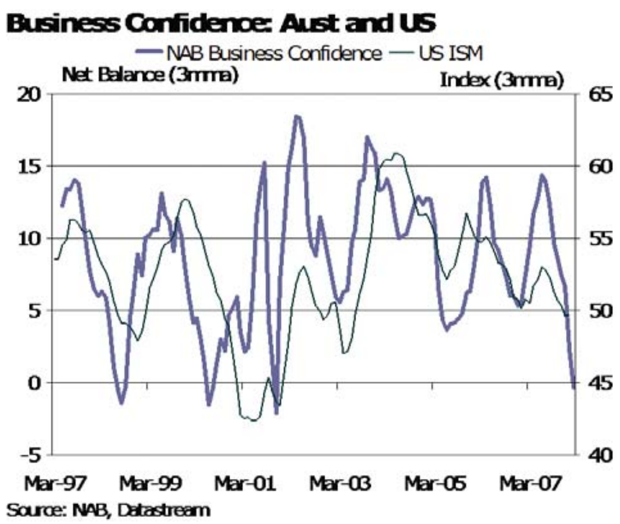


FIG 23B

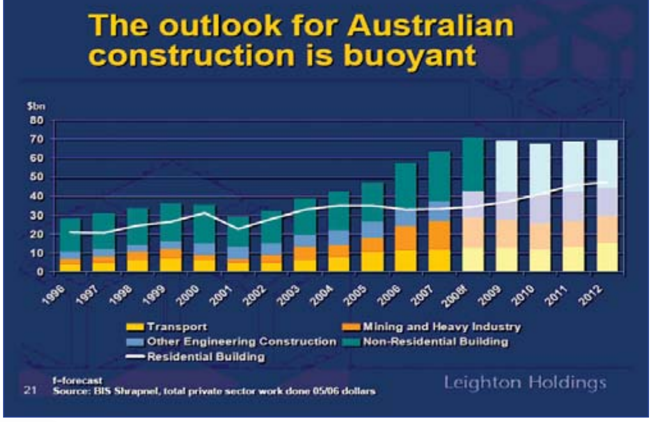


The risk for financial markets is that given the structural nature of inflationary pressures, financial conditions are tightened even further. This will put considerable pressure on household income and asset values. The following Fig 24 makes it pretty clear where the economy is heading.

FIG 24 **Economic growth to slow sharply**

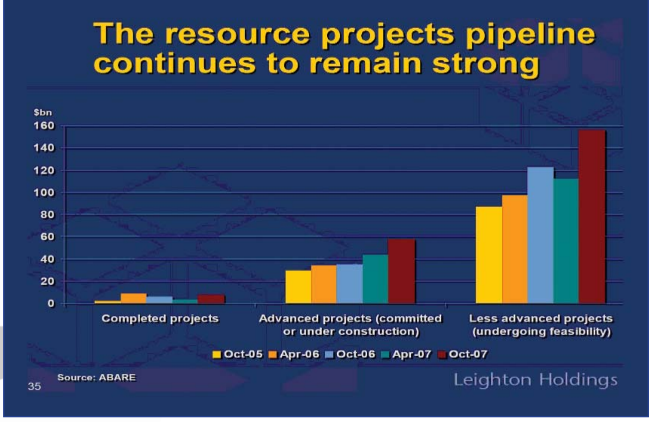
It would all be fairly gloomy if not for the ongoing support from the resources and infrastructure boom and a further firming of the terms of trade from stronger soft and bulk commodity prices in the year ahead.

FIG 25



The resources story just keeps getting better. The price increases for bulk commodities in the first quarter of this year were extraordinary and will underwrite a further round of expansion. In spite of

FIG 26



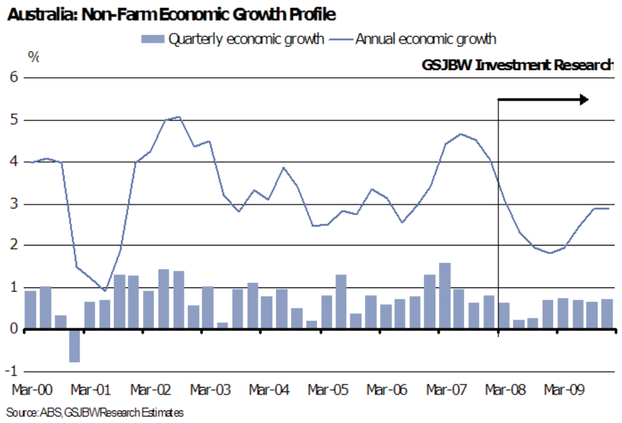
the credit crisis and the slowdown in OECD regions the project pipeline has continued to grow.

Capital investment committed and funded by governments and businesses alike will continue to support the domestic economy in spite of a sharp contraction in the household sector. The economy will hold together but it certainly won't feel like it.

You can already see the divergence in activity levels in the recently released GDP data. For the first quarter of 2008 production measures of economic growth were far stronger than the expenditure measures of growth as spending contracted sharply.

Our base case forecast for the domestic economy is for a 'soft landing' with activity moving modestly below trend (Fig 27).

FIG 27 **Domestic Economy Slows**



Outlook for Australian Equities

So what does this all mean for profit growth and equity markets? Firstly, it's important to recognise that we have just witnessed the longest period of margin expansion in a generation (Fig 28).

FIG 28 **Australia: Margins Cycles and the Terms of Trades**

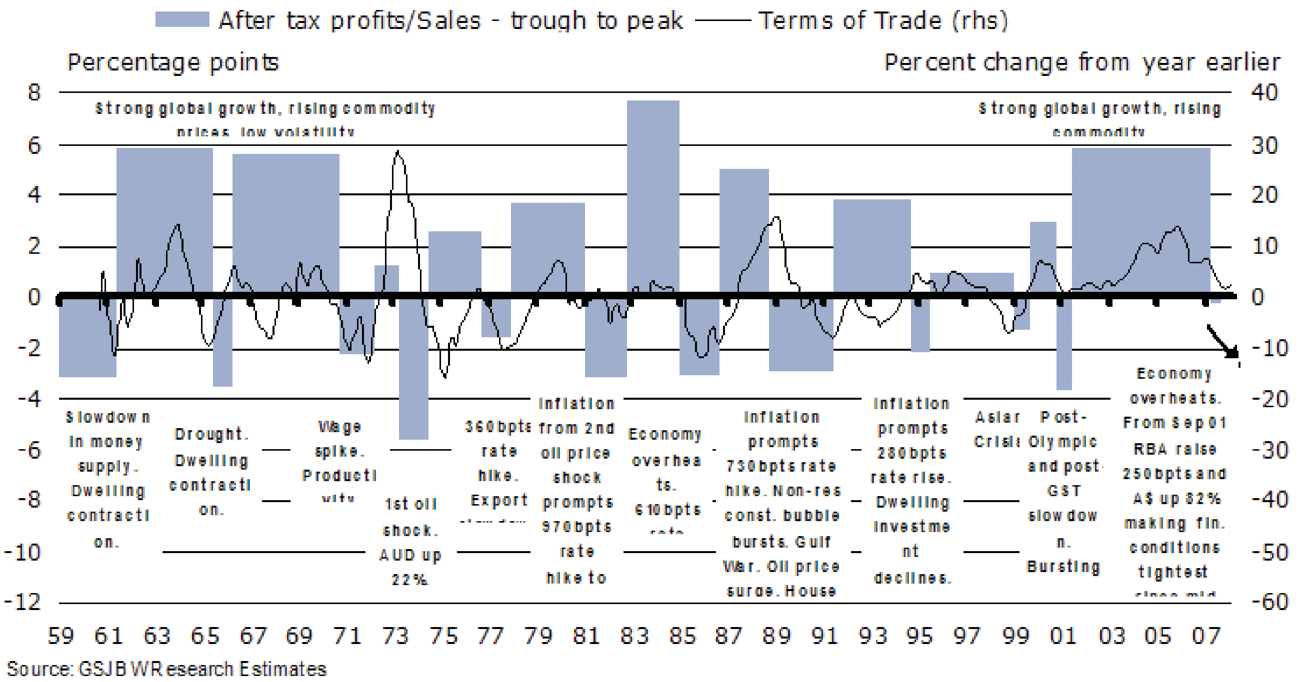


FIG 29A **Companies are achieving very high returns following 18 years of expansion**

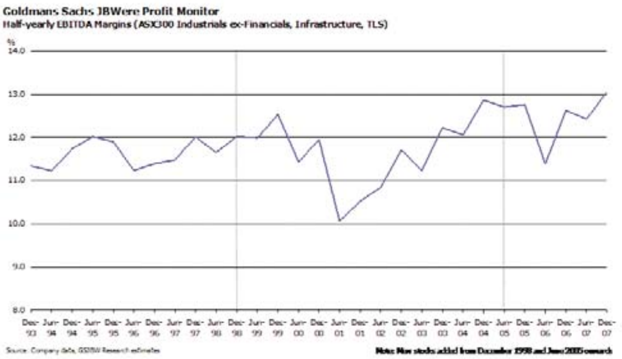


FIG 30 **Profit forecasts are still too high**

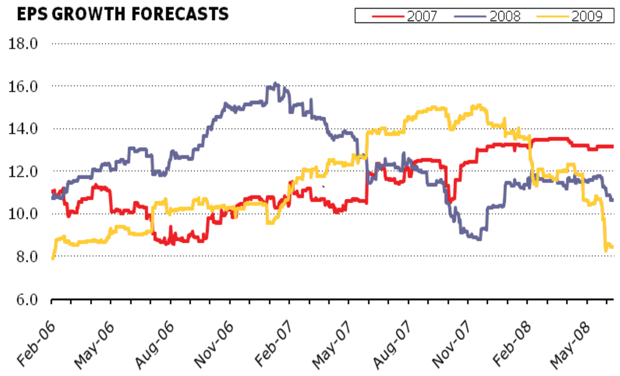


FIG 29B

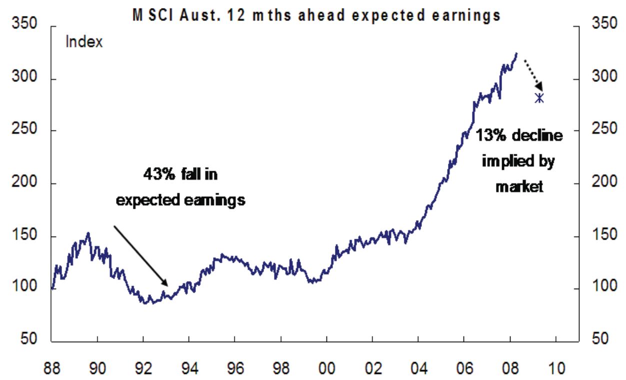
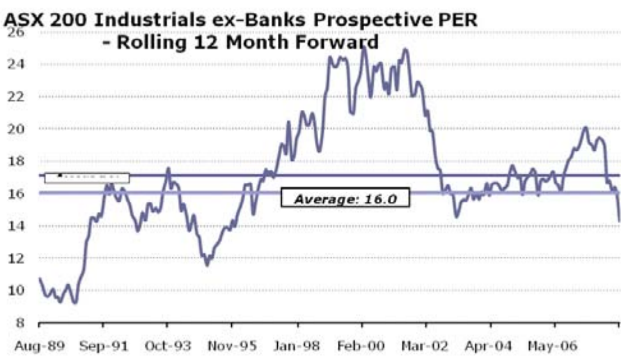


FIG 31 **Market looks cheap based on forecast profits**



Not surprisingly profits have soared (Fig 29A and 29B). The risk is that with margins and returns having expanded so much, they potentially have a long way to fall!

Investors need to evaluate the extent of profit contraction in the challenging environment ahead. While analysts have slashed forecast profit growth for industrial companies from 14% back in August 2007 to 7% currently (Fig 30), history has shown analysts are notoriously slow to adjust to changes in the cycle.

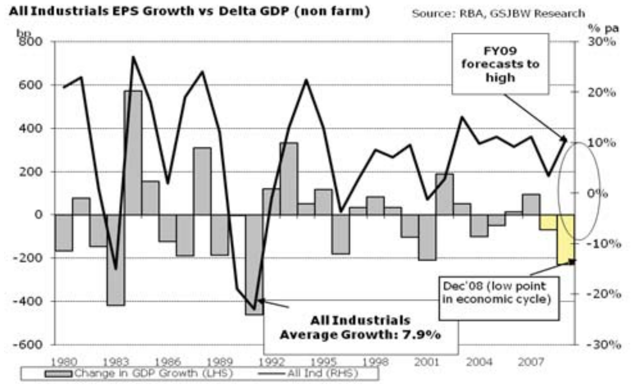
So while the market is clearly looking cheap based on these profit forecasts, the cheapest in fact in 15 years, the forecasts are almost certainly too optimistic. The fourth coming profit reporting season in August is going to be very disappointing and will prove the next major hurdle for the market. A simple analysis of valuation based on earnings forecasts (Fig 31) is somewhat misleading as the earnings forecast are too optimistic.

Another way to consider the profit outlook is to take a top-down perspective based on historic experience and forecast profit growth next year under a 'soft landing' scenario.

In Fig32 the left hand axis depicts the change in the rate of growth of the economy. You can see in 1983 and 1991 the economy suffered a "Hard Landing" growth slowed by at least 400 basis points and profits fell by between 10-20%.

In 2001 we experienced a 'soft landing' of sorts and corporate profits were flat in that year. Our base case is for a similar outcome in 2009 with the economy slowing by 200 basis points suggesting profit growth will be closer to zero then 7% currently forecast.

FIG 32 **Soft or Hard landing? Impact on profits**



The table below (Fig33) is a valuation matrix for the S&P/ASX 200 under different scenarios for 2009 profits.

FIG 33 **S&P/ASX200 Market Forecast - December 2008**

Prospective PER Multiple

FY09 Industrial EPS Growth	12.0	13.0	14.0	15.0	16.0
-20.0%	4,909	5,112	5,315	5,518	5,720
-15.0%	5,061	5,277	5,492	5,708	5,923
-10.0%	5,213	5,441	5,670	5,898	6,126
-5.0%	5,365	5,606	5,847	6,088	6,329
0.0%	5,518	5,771	6,025	6,278	6,532
4.0%	5,639	5,903	6,167	6,431	6,694
8.0%	5,761	6,035	6,309	6,583	6,857
12.0%	5,883	6,167	6,451	6,735	7,019

Source: GSJBW Research estimates

With zero growth in profits next year (soft landing), the market would be fairly valued with the index at 5771 adopting a conservative multiple of S&P/ASX 200 earnings. This is probably a reasonable 12 month target for the market (13% upside).

Looking at a downside scenario, with inflation and commodity prices moving higher, the central bank would be forced to tighten policy further, pushing the economy into a 'hard landing'. Earnings would likely fall by 10-25%. Under this bear case outcome, the end of year target is 5000 with the market probably moving lower in the interim. The important message is that with the index already testing 5000 currently (2nd July) a hard landing scenario is already priced in.

Given we place a low probability of a hard landing prevailing in 2009, we can only conclude equities are cheap and represent the best value we have seen for many years.

We see more risk with international markets and the prospect of a hard landing elsewhere. Particularly given the US, Japan and parts of Europe are all teetering on recession and inflation has broken out in emerging markets. If equities in these regions move lower as a 'hard landing' scenario is priced in, our market will inevitably follow.

Even though local equities are attractively priced, it would be sensible to wait for better clarity on the depth and duration of the downturn in these markets before calling the bottom. Either way, there will be outstanding opportunities to accumulate great companies at attractive prices in the months ahead.

Investment Process

In the second part of the report we revisit some of the differences between Australian Leaders and the more traditional funds in which you can invest. You will also find a detailed explanation on how the company funds its investment portfolio. In particular we dispel some of the myths around hedge funds and short selling.

Almost without exception most funds are managed within a traditional investment framework. These funds are managed to a strict set of rules largely governed by investment consultants. These consultants act as gatekeepers to the industry in awarding mandates and determining the direction and flow of funds.

As a consequence of this, fund managers are restricted in their ability to take positions that are materially different to the broader market portfolio (i.e the index). Most large institutional portfolios are little more than a duplication of the broader market and their investment objective reflects this. Risk limits around individual stock and sector positions are rigorously enforced ensuring a return outcome that is not materially different to the market even if the fund manager gets everything wrong. There is actually a term for this – 'tracking error'.

The consultant is also generally responsible for decisions on asset allocation; deciding when to move in and out of equities and leaving the fund manager with the task of managing a fully invested portfolio through the asset pricing cycle. As few managers have the option of short selling or retaining cash, the fund is fully invested even at times when equities are deemed expensive.

The clearest evidence of this institutional method of investing can be found in the performance numbers. Over the last seven years using the latest InTech data, the average manager has outperformed the index by just over 1%, top quartile managers have outperformed by 1.4%. This is what the vast majority of funds are designed to do.

Short selling is an attractive source of funding to enhance returns without adding market-based risk

ALF is different to a traditional fund and is referred to more broadly as an Alternative Investment Fund. In fact any investment structure that is not 'traditional' in complying with the stringent process outlined above can be referred to more broadly as an alternate investment or hedge fund depending on your parlance.

It is unfortunate that the term hedge fund which refers to anything other than a traditional fund, has been tarnished with every failed investment scheme. The reality is there are almost as many types of hedge funds as there are individual funds. You have macro funds that try to pick economic outcomes, there are event-driven funds that focus on large transactions, currency funds and the list goes on.

Where institutional mandates are designed to deliver modest outperformance over time (the best ones outperforming by 1.4%), hedge funds are looking for much higher returns.

While highly successful alternate investment funds have been a feature of capital markets in North America for many years, they emerged more recently in Australia.

So where does ALF fit into this landscape? ALF combines a traditional, fundamentally driven stock selection process with a more dynamic funding structure.

The easiest way to understand the differences between ALF and a traditional fund is to consider the company's balance sheet.

The asset side of the company's balance sheet is no different in many ways to a traditional fund, except as an absolute value manager we will only invest where we can identify value. Otherwise we will hold cash. This is a more active approach to portfolio construction than would be employed by an 'index aware' manager who inevitably hold a bit of everything and are limited in their ability to hold cash (the consultant makes the allocation decision).

The key difference between ALF and a more traditional fund is found on the funding side of the balance sheet. A traditional manager will only use shareholder's capital to fund the portfolio.

ALF like most companies, employs both debt and equity to fund the company's balance sheet. However whilst most companies borrow debt with a fixed value, Australian Leaders borrows securities that are listed shares. These shares are sold (shorting) with the funds raised either invested in the portfolio or retained as cash. However, unlike traditional debt, the value of the liability will move up and down with the value of the underlying shares that have been borrowed.

This type of funding structure has many benefits. The value of the liability (borrowed shares) will typically move in tandem with the value of the assets held in the portfolio, as both are tied to movements in the broader share market. If the market falls sharply, the value of the liability will also fall providing some protection to shareholders funds.

Short selling leverages investor returns to the security selection ability of the manager and not to movements in the broader market. So long as the assets in the portfolio (shares and cash) outperform the borrowed shares, investment returns are enhanced.

You may be surprised to discover that the carrying costs are extremely low on borrowed securities. It cost ALF 0.5% to borrow the shares of most ASX 200 companies. We borrow the shares from the same prime broker who acts as the company's custodian, UBS Australia. This is an attractive source of funding as securities can be sold for more than they are worth. As the securities are overvalued, it is our expectation that they will underperform in the medium term and provide a cheap source of funding for our portfolio.

In practice we are employing a similar security selection and portfolio construction process as a traditional portfolio but with a different funding structure. We rank the universe of ASX-listed securities from most attractive to least attractive by various selection criteria. Instead of just investing in the most attractive companies, we also sell the least attractive ones (borrowed) and put the extra funds into the portfolio of companies we like.

Short selling is seen as an attractive, supplementary source of funding for the balance sheet to enhance returns without adding market-based risk. In addition to short selling, if equity markets are materially undervalued, we may look to use finance to leverage returns to a broader market recovery.

The funded structure of the balance sheet will vary at times depending on the opportunities and risks identified in the equity markets. Gearing overall is set at conservative levels and is not dissimilar to what you may expect from a typical listed company.

Security Selection:

The Manager believes the best '*shorting*' opportunities are found in *poorly* managed companies with weak fundamentals that can be sold for *more* than their 'appraised value'.

Target companies to short with demonstrate a combination of the following:

- A history of inferior returns
- Management with a poor track record
- Businesses that are highly competitive and struggling to grow
- Securities that are expensive on a range of valuation measures

The security selection themes in identifying shorting opportunities are similar to those pursued in identifying investment ideas for the portfolio, just the opposite. We look to:

- Sell companies that are performing well above trend. They are more likely to be fully valued.
- Sell the most popular companies. The good news is more than likely priced in.
- Sell industries that have benefited from speculative capital. They are more than likely overpriced.
- Sell companies that offer investors short term rewards at the expense of longer term value.

We all know of companies that have failed to appreciate in value over time. If their value is unchanged we have accessed funding at negligible cost. Even if the value of these shares appreciates in value, while it is more expensive funding, if the funds have been reinvested in shares in the portfolio that performed better then we have enhanced overall returns.

Portfolio Construction:

In constructing a 'short portfolio' the manager embraces the same process as employed in constructing the investment portfolio. A portfolio of the best individual short ideas are taken from the investment universe of ASX 200 securities, with a bias toward shorting weaker businesses which we consider overvalued.

Performance to date:

Short selling has added significantly to performance over the last 18 months since we started collecting separate attribution data. For the period from 1 January 2007 to June 2008 the combined short portfolio fell in value by 21%. The market over this same period was flat. In simple terms, the value of the liability fell by 21% (profit) and we benefited from the returns generated from re-investing the funds in the portfolio.

Overall the fund has underperformed the benchmark by 1.9% in the 2008 financial year because of the weak performance of the securities in the investment portfolio. If the investment portfolio had performed in line with the market, the fund would have outperformed by more than 5% based on the short selling contribution alone. We have therefore increased the short funding activity more recently as it has consistently added to investment performance.

Investment performance last year was disappointing. However it would have been worse if not for the contribution from short selling. This year we are focused on driving performance from both sides of the ledger.

In summary:

- Global equity markets will struggle until we gain clarity on the depth and duration of the economic downturn.
- While global equities are attractively priced, the profit outlook is poor and investors looking for a soft landing are likely to be disappointed.
- Economic activity in Australia will soften but remain well above recessionary levels. Household spending will fall sharply in response to tightening monetary conditions.
- Inflation continues to be a major risk as we move into a period of resource scarcity.

For those who are willing to be patient, this is an opportune time to add to your share portfolio.

Please note Australian Leaders Limited has launched its website www.australianleaders.com.au. All investor releases including annual reports, quarterly newsletters and stock exchange announcements are listed on the site. We have also provided further detail on the investment process. I encourage you to visit the site to keep up to date with the latest announcements. ■

Justin Braitling | CHAIRMAN

PORTFOLIO PERFORMANCE

Gross Performance	1 month	3 month	6 month	Financial YTD 07
Wilson Leaders Ltd	-7.01%	-1.20%	-18.72%	-14.04%
All Ords Accum	-7.32%	-0.63%	-15.22%	-12.12%
Relative Performance	+0.31%	-0.57%	-3.50%	-1.92%

PORTFOLIO STRUCTURE

	As at 31 May 2008		As at 30 June 2008	
Investment Type	**$m**	**$m**	**$m**	**% of net assets**
Listed Securities	108.56	124.65%	128.39	160.70%
Fixed interest and Cash	24.75	28.41%	2.01	2.52%
Gross Assets	**133.31**	**153.06%**	**130.40**	**163.22%**
Short positions	-46.21	-53.06%	-50.51	-63.22%
Net Assets	**87.10**	**100.00%**	**79.89**	**100.00%**

The listed securities portfolio is detailed on the following page.

As at 30 June 2008 the equity portfolio gave exposre to:

Consumer Discretionary		
Aristocrat Leisure Ltd.	3,595,200	2.80%
Crown Ltd.	3,964,470	3.09%
Harvey Norman Holdings Ltd.	2,472,000	1.93%
Sky City Entertainment Group Ltd.	2,096,700	1.63%
TABCorp Holdings Ltd.	784,800	0.61%
Wotif.com Holdings Ltd.	1,974,000	1.54%
	14,887,170	**11.6%**
Media		
Austereo Group Ltd.	3,460,736	2.70%
APN News & Media Ltd.	1,147,297	0.89%
Consolidated Media Holdings Ltd.	1,690,798	1.32%
News Corp.	3,340,995	2.60%
Village Roadshow Ltd Prf A	2,285,734	1.78%
West Australian Newspapers Holdings Ltd.	1,314,268	1.02%
	13,239,828	**10.31%**
Consumer Staples		
Coca-Cola Amatil Ltd.	1,752,500	1.36%
Select Harvests Ltd.	1,186,272	0.92%
Woolworths Ltd.	3,056,250	2.39%
	5,995,022	**4.67%**
Engery		
Oil Search Ltd.	4,664,208	3.64%
Paladin Energy Ltd.	596,130	0.46%
Roc Oil Co. Ltd.	1,263,750	0.98%
Sunshine Gas Ltd.	607,500	0.47%
	7,131,588	**5.55%**
Financials		
Australia & New Zealand Banking Group Ltd.	5,801,328	4.52%
Commonwealth Bank of Australia	5,951,186	4.64%
Macquarie Group Ltd.	3,550,720	2.77%
National Australia Bank Ltd.	7,339,043	5.71%
Westpac Banking Corp.	5,456,000	4.25%
	28,098,277	**21.89%**
Diversified Financials		
ASX Ltd.	3,768,000	2.93%
Henderson Group PLC	1,433,432	1.12%
	5,201,432	**4.05%**
Insurance		
AXA Asia Pacific Holdings Ltd.	2,667,600	2.08%
QBE Insurance Group Ltd.	2,583,392	2.01%
Suncorp-Metway Ltd.	2,608,000	2.03%
Tower Ltd.	1,483,178	1.16%
	9,342,170	**7.28%**
Real Estate		
Lend Lease Corp. Ltd.	3,939,375	3.07%
Stockland Australia	1,492,599	1.16%
	5,431,974	**4.23%**
Health Care		
Primary Health Care Ltd.	4,337,741	3.37%
ResMed Inc. (CDI-10CDI/1SHS)	726,000	0.57%
	5,063,741	**3.94%**
Industrials		
Brambles Ltd.	1,309,500	1.02%
Leighton Holdings Ltd.	915,300	0.71%
Qantas Airways Ltd.	2,675,200	2.09%
SEEK Ltd.	1,700,090	1.32%
Toll Holdings Ltd.	1,324,400	1.03%
	7,924,490	**6.17%**
Information Technology		
Computershare Ltd.	1,289,400	1.00%
	1,289,400	**1.00%**
Materials		
BHP Billiton Ltd.	9,614,000	7.49%
Gunns Ltd.	598,020	0.47%
Mount Gibson Iron Ltd.	936,000	0.73%
Newcrest Mining Ltd.	2,262,546	1.76%
Orica Ltd.	922,950	0.72%
Rio Tinto Ltd.	1,084,000	0.84%
	15,417,516	**12.01%**
Telecommunication Services		
Reverse Corp. Ltd.	3,427,348	2.67%
Telstra Corp. Ltd.	4,141,450	3.23%
	7,568,797	**5.90%**
Utilities		
AGL Energy Ltd.	1,801,800	1.40%
	1,801,800	**1.40%**
SHORT PORTFOLIO	-50,507,034	

Notes:

Notes:

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