

The Leading Edge



Market Outlook: Trouble ahead in advanced economies

Investors have had little to cheer about following a northern summer of political and economic turmoil in the US and Europe. The year started badly with the devastation caused by the tsunami in Japan, only to be followed by the re-emergence of sovereign debt issues in Europe and a bitter battle over the US debt ceiling. These events have undermined confidence and brought into question the sustainability of this recovery.

Unfortunately, many of the structural imbalances that have hindered growth in this recovery are still to be addressed. The damage done to both public and private sector solvency by the "Great Recession" will take years to repair. With households and governments spending less to reduce debt, the outlook for advanced economies looks anaemic at best. While growth in developing regions is still robust, we are seeing a clear loss of momentum as China and India act to contain inflation.

In Europe, the second Greek rescue package reduced the risk of a disorderly default and exit from the Euro; however, the scale of debt reduction was insufficient to restore solvency. In the absence of politically unpalatable fiscal integration, we would expect to see similar debt rescheduling in a series of European countries in the coming years.

The European sovereign debt crisis is still a long way from being resolved. The deterioration in risk spreads on the sovereign issues of Italy and Spain is alarming. If these countries were to lose market access, we would quickly end up with a full-blown financial crisis similar to what followed the collapse of Lehman Brothers.

The US is facing its own debt crisis—self-inflicted, it seems—thanks to partisan politics being played out at the expense of the country's debt rating. The Budget Control Act of 2011 raised the debt limit by \$2.1 trillion, enough to allow the federal government to continue borrowing money until 2013. Discretionary spending has been cut and caps have been put in place for the next 10 years. A joint committee of Congress is charged with further reducing future deficits. This second round of austerity measures is likely to be just as bitter and divisive as the debate over the debt ceiling. Like Greece, we are only in the early chapters of an ongoing saga.

While the Budget Control Act reductions are backend weighted and fairly small, they come on top of the substantial fiscal tightening that was already in place prior to the passage of the debt deal. This tightening follows the automatic expiration of temporary stimulus measures adopted through the 2009 Recovery Act. These programs are all due to expire in the next year. Cumulatively, they represent a drag of 1.5-2% on growth as they are withdrawn. Given that the economy has only grown at 1.6% over the last four quarters, one can see why markets are fearful of a return to recession.

This situation is exacerbated further by the poor financial position of a number of US states and municipalities – many are in bad shape having relied heavily on federal stimulus money, which ran out at the end of June, 46 states have passed balanced budgets that include big cuts to spending.

The US is not alone in looking to tighten fiscal spending at a time when the recovery looks vulnerable. Britain is tightening by more than 3% in 2011 and 2012, with harsher versions underway in Ireland and the European periphery. Greece is retrenching by 16% over three years. Canada, France and Germany will all tighten in 2012.

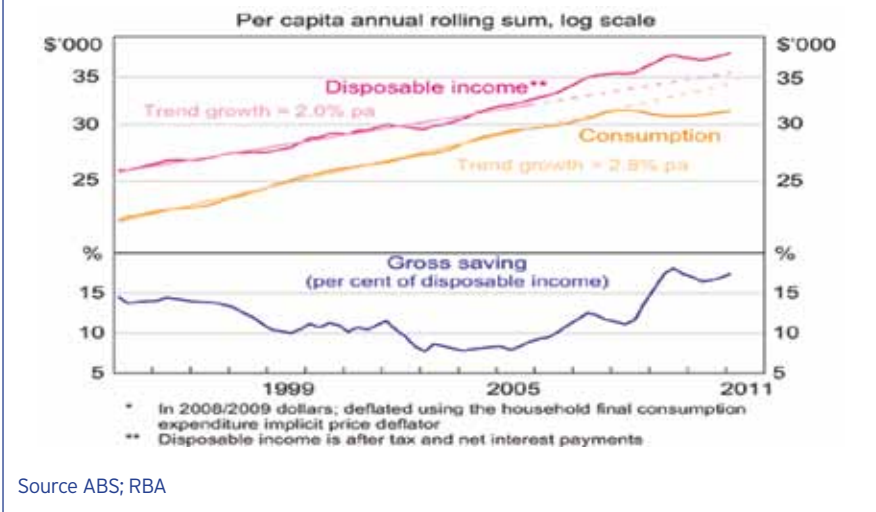
In the appendix to *The Leading Edge*, we explore the **"US Federal debt and the need for fiscal reform"** more fully and outline the task ahead if the US is to avoid a Japanese or Greek style quagmire. Simply put, with sovereign balance sheets in disrepair and demographic trends deteriorating, governments in the West will be forced to raise taxes and introduce further austerity, presenting a significant headwind to growth.

The outlook for Australia is more favourable

Australian households continue to act cautiously even though income growth has been strong in recent years as they save more and reduce debt (fig 1). This has curtailed private sector demand: As the savings rate has moved higher, consumption has lagged behind income growth. If the savings rate simply moderates at current levels, spending going forward should start to match income growth providing much needed relief to sectors exposed to household spending.

REAL HOUSEHOLD INCOME AND CONSUMPTION

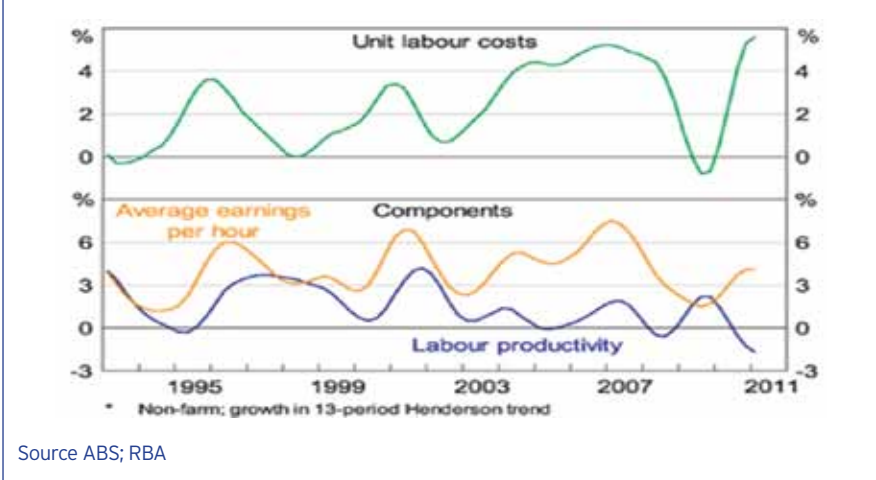
FIG 1



With the full thrust of the resources boom still to affect the economy through mining investments, the RBA will be reluctant to ease policy in the near future. The Central Bank remains hawkish, in spite of the challenges facing certain sectors of the economy, primarily because of poor supply side trends (Fig 2).

UNIT LABOUR COSTS GROWTH

FIG 2



Labour market productivity, an important buttress to economic growth, has all but stalled. Wages are breaking out across many industries as enterprise-based agreements are renegotiated under the new Fair Work legislation. This is a key risk factor for inflation as investment surges in the next few years.

An unpopular minority government pursuing additional taxes on the public is further undermining confidence, and this is unlikely to change before the next election. On a positive note, even if the western hemisphere moves back into recession, Australia should be able to weather the storm. The public purse is well funded providing ample scope to stimulate demand further. Corporate balance sheets are also very strong heading into a major investment phase. Lastly, the Central Bank has the scope to ease financial conditions from the current restrictive settings. With weak consumer confidence, soft employment data and growth well below the RBA's own estimate, interest rates are likely to be lowered before year-end.

While global equity markets are in a precarious state, with investors contemplating another recession, shares are inexpensive and the domestic fundamentals are strong. Suggesting equity markets should find support at current low levels.

In difficult times, it is essential that we invest in well-managed companies

In selecting companies to invest in and to sell (short), we spend considerable time evaluating management and looking closely at the business strategy and capital management decisions undertaken in the pursuit of shareholder value.

In the following sections, we take a closer look at these important measures of success. The first section, A New Paradigm for Banking in Australia, considers the divergent strategies pursued by the major banks as they struggle with tough credit conditions. We then review a selection of important acquisitions across a range of industries completed last year and seek to establish whether they were in the best interests of shareholders.

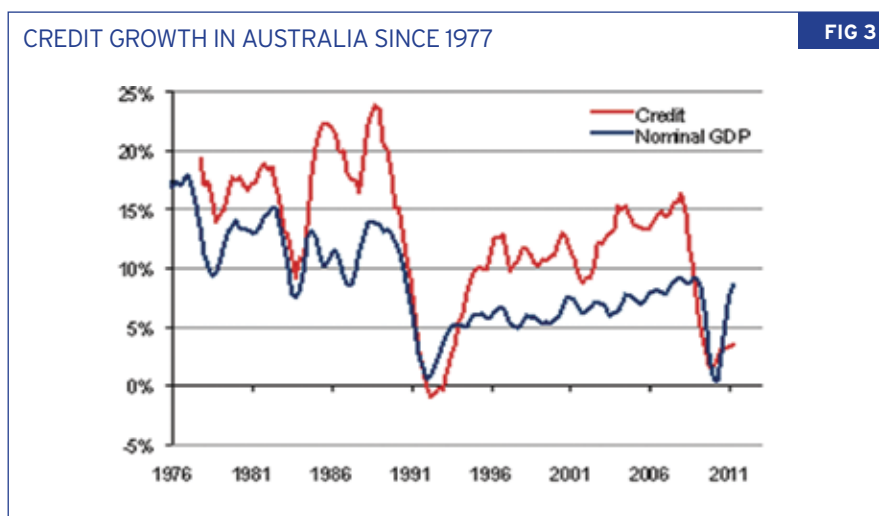
A New Paradigm of Banking in Australia: Which bank has the winning strategy?

Over the past 20 years, Australian banks have delivered exceptional returns in a thriving credit market. However, the Global Financial Crisis (GFC) created a more challenging environment for banks, both globally and within Australia. Credit spreads have re-priced, lending criteria have tightened and credit growth has stalled (Fig 3).

In Australia, a new era of consumer prudence has been fostered by rising interest rates, financial pressure and general uncertainty, with households reducing debt and de-leveraging.

In the past, Australian banks enjoyed the benefits of buoyant system growth without the need for a defining strategy. Australian lending was an unrivalled asset class in terms of both performance and quality. These easy credit conditions have been replaced by a myriad of new challenges with discerning customers and tougher banking regulations.

Fig 3 depicts the sharp deceleration in credit growth since the GFC.



Old Banking World 1980s/90s Financial Deregulation until 2007

- Lending grew well in excess of the underlying economy.
- Balance sheet growth is funded from easy access to wholesale funding offshore.
- Banks increase leverage as regulators ease prudential capital ratios.
- Intense competition arose from non-bank lenders in Australian housing.

New Banking World The Global Financial Crisis and Onwards

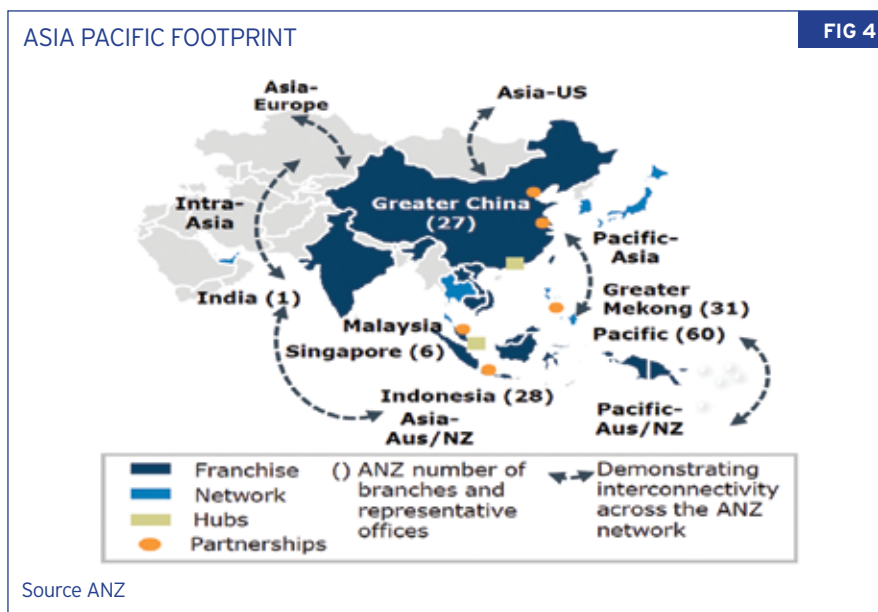
TAB 1

- Lending has slowed and is shrinking as a percentage of GDP as households and corporations deleverage.
- The days of cheap wholesale funding are over.
- Banks are forced to reduce their reliance on short-term wholesale funding.
- Non-bank lenders have exited with the closure of asset securitisation markets.
- The banking oligopoly is back, dominated by the four majors.

Prior to the GFC, banks could deliver strong growth simply by opening their doors for business. As the banks face a new period of lower growth, it is imperative that each one formulates and executes a new strategy to suit the times. We compare the different paths each has chosen.

ANZ - A Super Regional Strategy

After arriving at ANZ in 2007, incoming CEO Mike Smith outlined the Group's 10-year Super Regional strategy. The objective was to position ANZ as the leading regional trading bank in the Asia Pacific region. By embarking on a strategy that capitalises on strong Asian growth and the trade connectivity between markets, ANZ aspires to generate long-term returns that are unavailable to its domestic peers. The bank will look to leverage its leading Australian institutional trading business and to focus on investment flows through three key customer segments: Infrastructure, Resources and Agribusiness.



The strategy looks to position ANZ as the regional bank of choice for commercial institutions. Investment in regional office hubs in Hong Kong and Singapore and in a comprehensive branch network will extend ANZ's distribution and market expertise. Facilitation of Asian cross-border transactions will generate demand for banking services and credit by offering connectivity for regional trade and investment.

Through relationships built with its multinational corporate customers that trade with or from Asia, ANZ has positioned itself well as a trade intermediary. ANZ offers specialist services in cross-border banking including Debt Capital Market access, bond origination and foreign exchange and interest rate hedging, along with cash management and transaction services.

The focus is on generating fee income through providing services rather than from conventional balance sheet lending. ANZ is the domestic market leader in many of these segments, so leveraging these strengths offshore is a natural progression. This competitive space has been largely overlooked by the other Australian banks that were chastened by experiences of moving offshore. ANZ has quickly established itself as the fourth largest regional bank in Asia, behind HSBC, Citibank and Standard Chartered.

The Group's balance sheet also benefits from an alternate source of cheap deposits that are repatriated via the group treasury, providing a cheaper source of funding for Australian lending. As a result, the bank has been able to obtain a funding advantage, reducing its reliance on expensive domestic deposits and offshore wholesale funding.

ANZ's strategy, if executed correctly, will deliver growth that is clearly not available to its domestic rivals beholden to soft credit conditions in Australia.

TAB 2

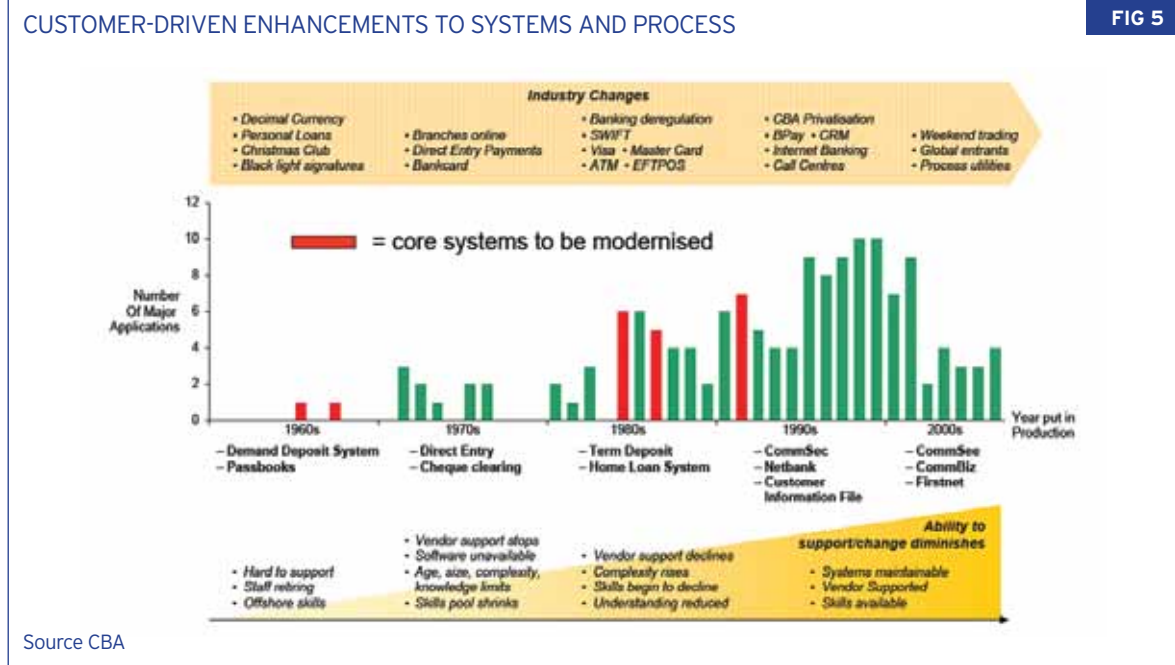
Key features of the ANZ Super Regional Strategy

- Unique Asian Focus**
 - Differentiated source of revenue growth.
 - A focus on fee generation reduces the bank’s reliance on conventional bank lending.
 - Cheap source of deposit origination, which can be used to fund Australian lending.
- Clear and Consistent Strategic Agenda**
 - ANZ aspires to become a leader in commodity driven markets - Resources, Agribusiness and Infrastructure.
 - Leverage Asia’s rapid growth and regional connectivity.
- Building Capabilities**
 - Asian growth is a function of business already obtained - linking customers and partnerships with innovative product.
 - Strategy builds upon existing domestic competitive advantage and expertise in institutional banking.
 - Roll-out core cash management and transaction banking platforms.

Commonwealth Bank of Australia (CBA) - Core Banking Modernisation

The four major Australian banks operate IT systems that, in many cases, are over 40 years old. CBA is committed to an ambitious program of modernising these platforms, providing a step change in the bank’s cost-to-service and extending its product offering.

In the good times past, there was little incentive to address the complex task of modernising the core banking process. Consequently, each bank is left with an inefficient conglomeration of legacy systems cobbled together over the past 50 years.



In April 2008, CBA announced a four-year Core Banking Modernisation (CBM) program. The centrepiece of the CBM is a “Real Time” banking platform that aims to improve customer service while reducing costs and the risk of legacy system failure.

Incredibly, Australian banks are still inefficiently batch processing cash transactions at the end of each day. By offering “Real Time” banking, CBA will provide a competitive advantage in customer service and product

development. For example, they now have the capacity to develop products that target specific customers by geographic or demographic group. Customer-tailored marketing campaigns can be implemented on a timely basis.

CBM is designed to put CBA at the forefront of modern banking. So far, CBA has successfully delivered the main project goals, albeit at a higher than budgeted cost.

CBA advantages versus peers		TAB 3
The Core Banking Modernisation	<ul style="list-style-type: none"> ■ Market leading investment in technology – three years ahead of its nearest competitor in terms of IT development and implementation. ■ Reorientation of the entire group to an industrialised banking business, delivering significant cost savings. ■ Flexible, quick and efficient product development through automated real time banking capabilities. ■ Enhanced customer service functionality through sophisticated customer analysis. ■ Risk mitigation of legacy system failure. 	

NAB - A price lead strategy

Since emerging from Australia's own banking crisis in the early 1990's in a relatively strong position, NAB has underperformed its peers following a succession of poor capital management decisions.

A decade ago, inadequate risk management and supervision led to a \$2.2 billion loss on its investment in the US mortgage lender HomeSide. Three years later, \$360 million was lost through unauthorised trading in NAB's foreign exchange division and more recently over \$1 billion was written off a portfolio of exotic Synthetic Collateralised Debt Obligations (SCDOs).

While NAB is the pre-eminent banker of choice for small businesses, the retail bank is small having perennially underperformed. Poor customer satisfaction and underinvestment in branch banking has resulted in a steady leakage of customers.

NAB's strategy is relatively straightforward: protect and defend its strong share of business lending while aggressively growing the retail business that is sub-scale relative to the other majors.

NAB has embarked on a campaign to win market share from Westpac and CBA by cutting product fees and lending margins. Its "fair value" proposition has intensified retail competition in an industry comfort zone. While NAB's branch network is weaker, it has been able to gain customers via brokers who have jumped at

NAB is a turnaround story		TAB 4
"Break Up" fair value strategy	<ul style="list-style-type: none"> ■ Rebuilding the retail bank – a perennial underperformer. ■ Differentiation through price and marketing initiatives that seek to acquire disenfranchised customers from peer banks. ■ Strong growth versus peers in higher margin personal banking. 	
Business Banking in Australia and NZ	<ul style="list-style-type: none"> ■ Leading position in Australian SME business lending. ■ Significant repricing benefits achieved in business banking. ■ Strong leverage to a return in business credit growth. 	
UK Turnaround	<ul style="list-style-type: none"> ■ New operating model has been well established in the UK. ■ Results in the UK so far have been masked by very difficult economic and banking conditions. 	

the attractive terms. The innovative “Break-Up Campaign” has gained traction with retail customers, with the group growing mortgage lending three times faster than its peers so far this year.

We would not typically endorse a price lead strategy in an oligopoly. However, NAB has clearly hit a chord with households who are sick of being exploited and are keenly seeking value. It is probably the right strategy for these difficult times.

While attractive rates have won over many new customers, the bank now needs to address lingering service and quality issues that have undermined success in the past. With the highest complaint level and slowest loan approval rates of the big four, it clearly still has a lot to do.




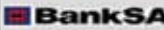



Undoubtedly, NAB has been the most aggressive of the four majors, agitating a listless banking oligopoly and growing at the expense of its peers.

Westpac (WBC) - A House of Brands

Together, Westpac and CBA dominate retail banking in Australia and New Zealand, jointly managing well over half of all deposits and mortgages. Westpac’s strategy is to maximise customer reach through a portfolio of regional and national brands with a “local” banking focus.

Following the acquisition of St George and RAMS in 2008, Westpac has pooled together a collection of regional and national brands, with each brand offering customers a different proposition. In its latest move, Westpac has relaunched the Bank of Melbourne in Victoria, with plans to roll out up to 100 branches over five years.

The range of powerful brands, as shown below, increases Westpac’s strategic flexibility by positioning different brands to serve different customer needs in varying markets, thereby maximising cross-sell opportunities.

HOUSE OF BRANDS			FIG 6
Business	Brand	Segment	% FY10 Earnings
Westpac Retail & Business Banking		Consumer & SME	30
		Mortgages	
St. George Bank		Consumer, SME & some corporate	18
			
			
Westpac New Zealand		Consumer & SME	4
BT Financial Group		Wealth/ insurance	10
Westpac Institutional Bank		Corporate & Institutional	26

Source WBC

Westpac describes its strategy as customer-centric, with the “local” banking approach maximising products per customer by strengthening client relationships. This has been successfully executed with the St. George acquisition, where customer retention has been high. At the corporate centre, institutional and treasury functions cater to larger accounts and customers who prefer to deal with a national bank, while each regional bank services customers looking for a community based relationship.

Westpac salient attributes versus peers

Very strong retail position	<ul style="list-style-type: none"> ■ 98% of assets in Australia and New Zealand ■ Most focused on Australia / New Zealand growth opportunities ■ Strong franchise position
Multi-brand strategy providing choice	<ul style="list-style-type: none"> ■ Regional banking strategy using St. George, Bank SA, Bank of Melbourne ■ Flexible and segmented offering
Strategically well placed with high quality portfolio	<ul style="list-style-type: none"> ■ Credit quality is superior, with strong provisioning and low impairments ■ Strong balance sheet strength with Tier 1 Capital of 9.5% at 31 March 2011 ■ Best positioned to transition to Basel III capital requirements

Conclusion

In the new paradigm of banking in Australia, strategy has become all-important to success. Banks can no longer ride the wave of system growth to achieve effortless rewards. In the future, bank performance is more likely to diverge as each player adopts a different set of tactics to cope with the tougher environment.

CBA and WBC are pursuing more defensive strategies, looking to optimise profitability through efficiency and scale. CBA has adopted a technology focus while WBC continues to invest in multiple brands. ANZ is looking to capture growth in Asia, a credible opportunity if well executed. In contrast, NAB is seeking to narrow the performance gap to its peers, defending its strong business bank while aggressively expanding its retail brand.

Australia's leading banks are adapting to these testing times. Returns will inevitably vary. The best results will be achieved by those banks that execute their chosen vision successfully.

The importance of capital management

Given our view of a fragile recovery, organic earnings growth will be sluggish for many companies. Armed with strong balance sheets after the GFC, management may look to supplement growth through acquisition.

The success of any major acquisition will be pivotal in this difficult trading environment. Companies that make poor capital decisions in tough times will pay the price for years to come.

We review a number of the larger deals completed in the last year, highlighting a selection of transactions that created and destroyed value for shareholders.

Each transaction should be considered on the following criteria:

- Does the acquisition make sense strategically and culturally?
- Is the combined business worth more than the separate parts?
- Was the price paid appropriate?

Brambles acquires IFCO Systems for £923M



Last November, Brambles (BKB) announced the acquisition of IFCO Systems NV. IFCO manufactures reusable plastic containers (RPCs) used for packing fruit and vegetables for grocery retailers in Europe and the US. Brambles, as a global leader of equipment pooling, is a natural owner of this business.

The acquisition is consistent with the company's strategy of expanding its core competence of asset pooling across a broad range of markets. IFCO gives Brambles immediate access to the fast-growing RPC sector in America. Under Brambles' ownership, penetration can accelerate by leveraging existing customer relationships. Brambles already operates an RPC business in Europe alongside IFCO and merging these businesses will deliver significant scale and efficiency benefits.

We believe Brambles acquired IFCO on attractive terms, based on its underlying growth prospects as well as the expected benefits that will flow from the merger. Brambles undertook extensive due diligence, gaining thorough access despite IFCO's listing on the Frankfurt Stock Exchange.

The value of ALF's shareholding in this well-managed company has appreciated accordingly.

WA Newspaper acquires Seven Media Group for \$4,085M



In February this year, West Australian Newspapers (WAN) announced its intention to acquire SMG from Seven Group Holdings (SGH). SMG comprises the Seven Network, Pacific Magazines and 50% of Yahoo!7. Given that SGH already controlled WAN with relevant board representation, this was clearly a related party transaction. While the deal received shareholder approval, in our opinion it was not in the best interests of WAN shareholders (Fig 8).

This large, diverse and company-transforming acquisition strayed from WAN's stated strategy and surprised many people. The rationale presented in supporting the transaction was that WAN had to diversify because newspaper publishing was a sunset industry. We question whether the move was value enhancing for shareholders, and we note the combination benefits were small.

While SMG remained shareholders in the new entity, we believe the acquisition price of \$4,085 million was very high. With profits in the Seven network peaking last year, WAN has paid a high price for these assets at the top of the cycle. Worse still, WAN shareholders are now left with a highly leveraged balance sheet as activity in the sector softens.

Lend Lease acquires Valemus for \$960M



Lend Lease (LLC) is a fully integrated property solutions provider that operates across the entire property value chain. In December, the company announced the acquisition of multi-service contractor Valemus from Bilfinger Berger. Valemus is a strong provider of engineering construction, asset management and engineering services.

The move was consistent with Lend Lease's strategic focus on infrastructure and urban regeneration. When considering the market sectors in which each company operates, we believe the two businesses complement each other nicely.

With the increasing size and complexity of major infrastructure projects, scale is becoming a competitive advantage. A select few property development companies have emerged from the GFC intact. Fewer companies still can access third party funds on any scale. Lend Lease now with Valemus is a clear leader in urban regeneration.

Bilfinger Berger (BB) attempted to float Valemus earlier in the year for \$1.2-1.4 billion, only to see the process come undone due to the sovereign debt crisis. With pressure mounting on BB to shed the business, Lend Lease was able to buy well below the IPO price, rewarding Lend Lease for its patience. While no official synergy targets were stated, benefits will clearly emerge under a single owner.

ALF's investment in Lend Lease has performed well after the transaction.

AMP acquires AXA Australia



The AMP / AXA merger ushers in an era of major change for AMP and also for the much broader wealth management industry. It creates the largest aligned planner force in the region, effectively doubling AMP's distribution footprint. Strategically, it removes AMP's long-term rival, significantly enhancing the competitiveness of the business.

AMP will leverage its sales and support infrastructure servicing the expanded planner force for little incremental cost. AMP had not yet developed its own WRAP platform but now has access to AXA's industry leading North product, increasing margins across the group's existing book of business. They will inevitably shift management of AXA funds across to AMP Capital, delivering further incremental revenue.

AMP exhibited strong price restraint during the bidding process. AXA's French parent, AXA SA eventually folded and sweetened the terms of the deal in AMP's favour, winning the support of AXA's independent directors.

In time, AMP will merge the various investment platforms along with the life companies providing significant benefits for both share and policy holders.

SABMiller bids for Foster's Ltd



SABMiller recently announced a conditional proposal to acquire Foster's for \$4.90 per share. While the Foster's board rejected the offer, deeming it inadequate, the offer highlights the value in the brewing business following the demerger of Treasury Wines Estates. Foster's has an outstanding beer portfolio with seven of the top ten brands in Australia, and is one of the most profitable beer businesses in the world.

However, over the last decade, while pursuing its multi-beverage strategy and cobbling together a global wine business the company has destroyed between \$5-6 billion of its shareholder value. With management distracted by wine acquisitions, the beer business drifted and lost focus with Australian drinkers as they embraced new premium and craft brands. SABMiller has identified an opportunity to reinvigorate Foster's tired beer portfolio employing its commercial expertise in beer marketing.

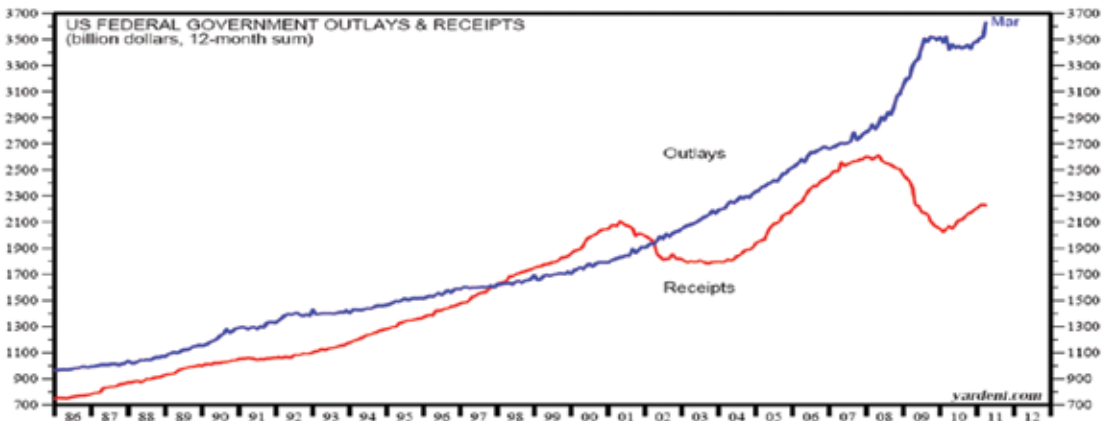
By demerging the beer and wine assets, Foster's was effectively put in play and is likely to attract strong interest from global breweries looking to secure a powerful market position in Australia. Businesses that are as strong and profitable as Foster's are rarely traded, it was not surprising to see SABMiller an astute consolidator of beer brands lodge an offer for this iconic Melbourne company.

Appendix 1: US Federal debt and the need for fiscal reform

A cursory review of fig # reveals the unsustainable spending path the US is on, with outlays growing well in excess of the underlying economy for over 20 years. While part of this deterioration is cyclical, as the government has provided support through the recession, the underlying trends are deeply concerning. I would encourage anyone interested in this topic to read Mary Meeker's report "US Inc." at www.kpcb.com/usainc

Runaway Outlays

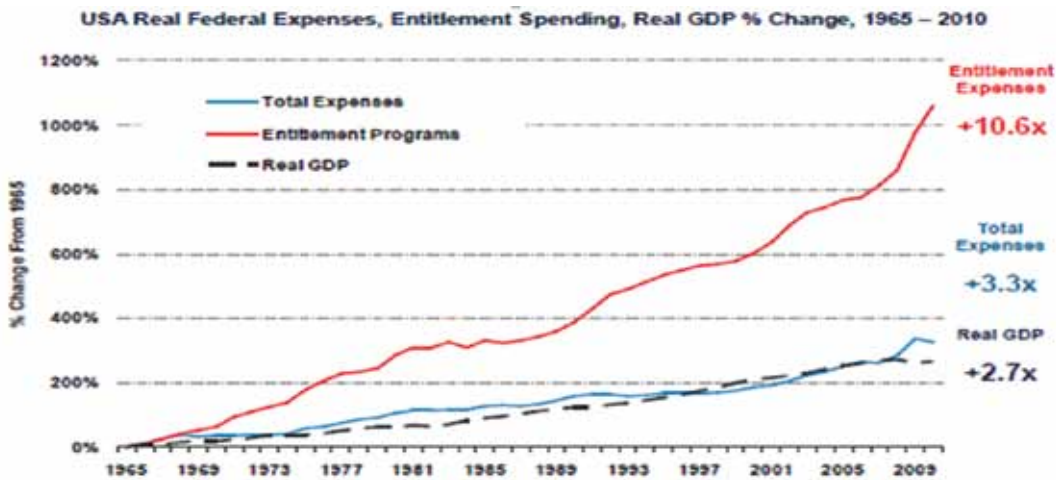
FIG 12



Source: US Treasury Department

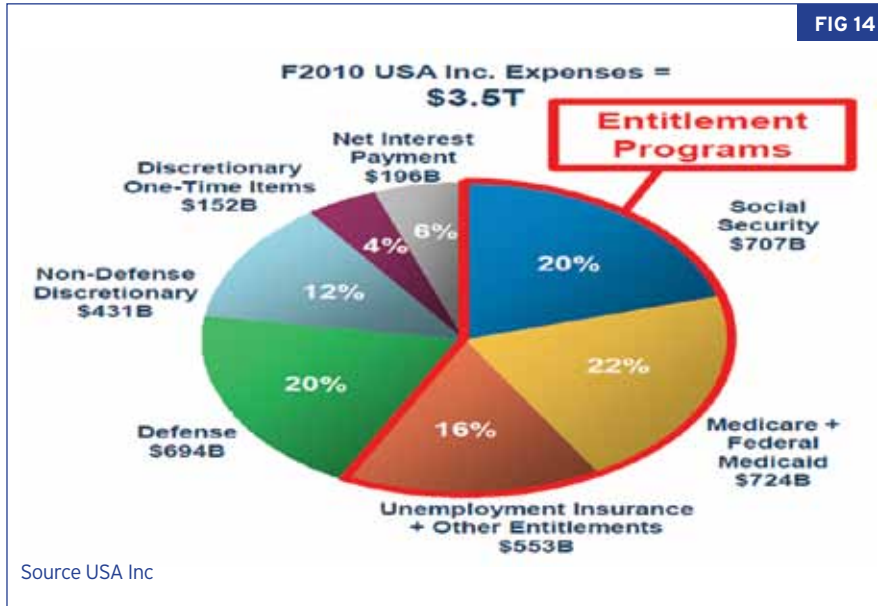
If we break the US Federal budget down into the various programs, one quickly discovers that unrestrained growth in entitlement spending is the root cause of the exponential growth in outlays (fig#). Discretionary spending on defence, infrastructure and education has more or less grown in line with the economy.

FIG 13



The real problem lies with non-discretionary entitlements, which are largely unfunded programs protected by legislation. They now account for over half of all budget outlays, having doubled in relevance over the last 30 years (fig 14). Based on demographic and cost inflation trends, these outlays are expected to grow well in excess of the economy.

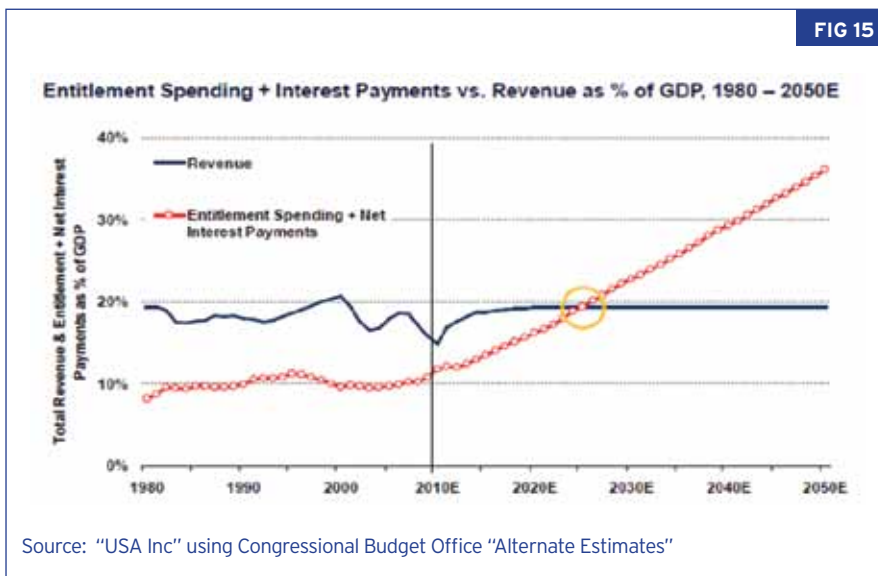
Entitlement spending on social security, unemployment and healthcare serves the nation's poorest, many of which have been further disadvantaged by the economic downturn. We shouldn't underestimate the considerable challenges facing lawmakers in reforming these programs. While there is general public support behind budget reform particularly following the debt ceiling debacle, there is little support for entitlement reform, which is the heart of the problem.



Social security and unemployment insurance are programs funded via payroll taxes, whereas healthcare entitlements via Medicaid for low income earnings and Medicare for the elderly are largely unfunded programs.

Demographic trends suggest this problem will get a lot worse if not addressed through entitlement reform, as the retired population will double as a percentage of the working population in the next 40 years.

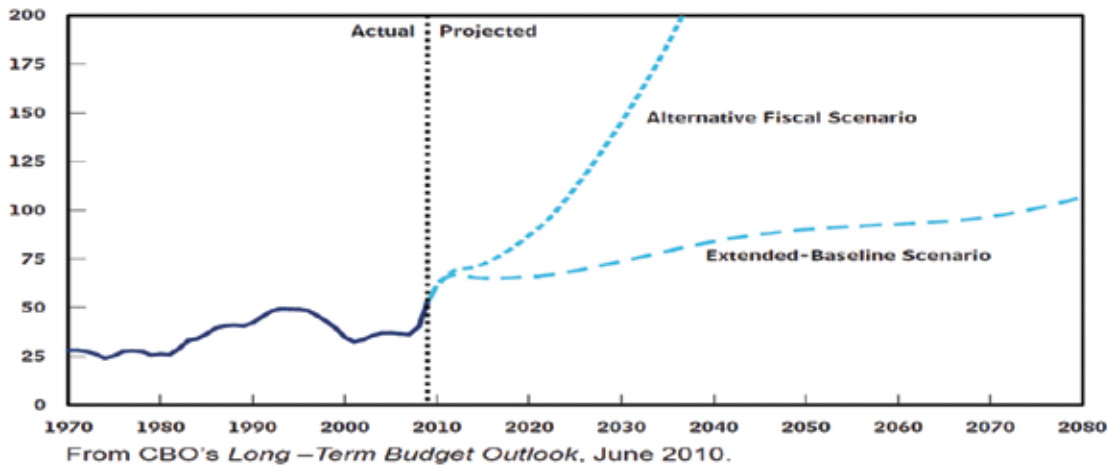
To give you a sense of how dire these trends are, based on the Congressional Budget Office's "Alternate" scenario (which assumes a continuation of the existing policy, with current demographic trends) the combined cost of entitlements and the interest on Federal debt will absorb all government revenues within 15 years, leaving nothing for anything else (i.e. defence, education, infrastructure and R&D etc.) Fig 15



The impact of the ongoing cash drain on the economy can be seen in the rapid deterioration in the Public Sector debt position. The GFC resulted in a meaningful shift in the debt burden from the private sector to the public sector. Stimulus measures and bank bailouts have pushed the Federal Debt balance to 60% of GDP (90% if you include the government agency debt that was nationalised).

PERCENTAGE OF GDP

FIG 16



Taking the CBO's own estimates, if nothing is done and entitlement spending continues to follow existing trends—which are largely legislated—then the outlook for the US is very grim, as the Debt/GDP ratio will move well beyond sustainable levels.

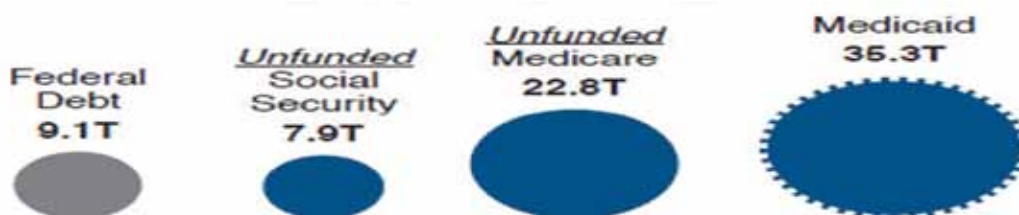
So how much debt is too much? Economists have suggested that a threshold exists where debt levels beyond 100% of GDP are quite destabilising and real GDP growth starts to slow dramatically. If we include the debts of the Government Sponsored Enterprises (GSE) in conservatorship, then the US federal debt is fast approaching 100% - somewhat disconcerting for a government that has to find investors for \$1 trillion of new treasuries each year to fund its deficit.

Mary Meeker, in her USA Inc. study, compares the US to a corporation. In many instances, the problems besetting the US are similar to those that have driven many old industrial giants like Bethlehem Steel and General Motors into bankruptcy. The pension and OPEB liabilities that are largely unfunded have overwhelmed the residual value of these companies. This is typical of companies that have downsized over many years and is also consistent with the demographics of an aging population.

These future entitlements are largely unfunded. Therefore, in the same way that a company would be forced to recognise these employee benefits as a liability, the government should arguably also report these liabilities on the balance sheet.

USA BALANCE SHEET LIABILITIES

FIG 17



Source: A Basic Summary of America's Financial Statements. USA Inc

What is startling is the size of these future claims in relation to the existing federal debt of \$9 trillion and the current outlays of \$725 billion (fig 16). Bill Gross at PIMCO has compared the federal debt that has received such attention recently to Pluto, barely meriting planetary status when compared to the far greater entitlement liabilities of Saturn and Jupiter.

If, hypothetically, the government were to set up a reserve (as companies do to meet these future claims) and fund it via 30-year treasuries, at the current rates of 4.5% the net interest bill would leap from \$200 billion annually to \$3.2 trillion and the deficit would move well beyond 15% of GDP.

To put these numbers in perspective, incorporating these liabilities on the country's balance sheet and funding them through the budget would leave the US with a net debt of 500% of GDP.

A failure to come up with a credible medium-term fiscal reform program would increase borrowing costs for everyone in the US, thereby undermining investment, employment and growth. Foreign investors would think twice about holding US assets and the dollar would weaken further.

The tighter the fiscal purse is pulled, the greater the onus that is placed on monetary policy to support the economy. Given the scale of the fiscal task, we can rest assured, in the absence of inflation pressures, that interest rates will stay low for a very long time.

While we have focused on US Sovereign debt concerns, many western countries are in a similar predicament following the GFC, and many face the same deteriorating demographic trends. Japan, for example, also has a rapidly aging population in which the workforce is already shrinking and the countries debt to GDP is already above 130%. It can ill afford to increase its dependent population. Similarly, the UK's Balance Sheet will pass the 90% threshold within a few years, after being forced to nationalise their larger banks following the financial crisis.

Sector Allocation (ASX) All positions as % of shareholder's funds

Company Name	Investment	%Long	%Short	Net Weight	ALL Ords Weight
DEFENSIVES	8,378,471	24%	-15%	9%	19
Infrastructure	MACQUARIE ATLAS ROAD GROUP	-2,401,000	0%	-2%	0.1%
Infrastructure	QR NATIONAL LTD	-2,440,800	0%	-2%	0.6%
Infrastructure	ASCIANO GROUP	4,534,207	5%	0%	0.4%
Infrastructure	CONNECTEAST GROUP	-2,508,419	0%	-3%	0.1%
Utilities	ORIGIN ENERGY	2,390,080	2%	0%	1.3%
Utilities	AGL ENERGY LTD	2,199,780	2%	0%	0.5%
Utilities	HASTINGS DIVERSIFIED UTILITIES	866,250	1%	0%	0.1%
Telecom	TELSTRA CORPORATION LTD	1,898,000	2%	0%	2.8%
Retailing Staples	WESFARMERS LTD.	2,695,350	3%	0%	2.5%
Healthcare	COCHLEAR LIMITED	-1,072,500	0%	-1%	0.3%
Healthcare	MESOBLAST	3,589,363	4%	0%	0.2%
Healthcare	ANSELL LTD	-4,571,598	0%	-5%	0.1%
Healthcare	RESMED INC	3,202,759	3%	0%	0.3%
Healthcare	RAMSAY HEALTH CARE LIMITED	-1,797,000	0%	-2%	0.3%
Gaming	CROWN LTD	1,794,000	2%	0%	0.5%
FINANCIALS	41,401,543	61%	-19%	42%	33%
Banks	COMMONWEALTH BANK OF AUSTRALIA	7,791,375	8%	0%	6.3%
Banks	NATIONAL AUSTRALIA BANK LTD	4,076,800	4%	0%	4.3%
Banks	WESTPAC BANKING CORP	8,480,228	9%	0%	5.1%
Banks	AUSTRALIA & NEW ZEALAND BANKING	7,437,494	7%	0%	4.4%
Banks	BENDIGO BANK LIMITED	-2,880,900	0%	-3%	0.2%
Diversified Financials	MACQUARIE GROUP LTD	2,058,471	2%	0%	0.8%
Diversified Financials	ASX LTD	1,510,000	2%	0%	0.4%
Diversified Financials	COMPUTERSHARE LIMITED	-1,571,400	0%	-2%	0.4%
Diversified Financials	IOOF	-1,052,800	0%	-1%	0.1%
Diversified Financials	HENDERSON GROUP PLC	3,981,653	4%	0%	0.1%
Insurance	QBE INSURANCE GROUP LIMITED	4,816,619	5%	0%	1.5%
Insurance	AMP LIMITED	3,734,500	4%	0%	1.1%
Insurance	SUNCORP-METWAY LTD	-2,856,000	0%	-3%	0.8%
Insurance	INSURANCE AUSTRALIA GROUP LTD	2,680,000	3%	0%	0.5%
Real Estate	STOCKLAND	4,641,966	5%	0%	0.6%
Real Estate	GPT GROUP	-5,652,000	0%	-6%	0.5%
Real Estate	LEND LEASE CORP	3,029,536	3%	0%	0.4%
Real Estate	DEXUS PROPERTY GROUP	-4,224,000	0%	-4%	0.3%
Real Estate	WESTFIELD RETAIL TRUST	5,400,000	5%	0%	0.6%
INDUSTRIAL CYCLICALS	6,197,040	30%	-23%	7%	12%
Media	NEWS CORP INC	5,423,109	6%	0%	1.0%
Media	TEN NETWORK	2,811,183	3%	0%	0.1%
Consumer Services	BRAMBLES LIMITED	2,163,000	2%	0%	0.8%
Consumer Services	NAVITAS LIMITED	-1,406,327	0%	-1%	0.1%
Contractors	UNITED GROUP	-2,236,800	0%	-2%	0.2%
Contractors	MACMAHON HOLDINGS LTD.	-999,000	0%	-1%	0.0%
Contractors	DOWNER EDI LIMITED	1,184,400	1%	0%	0.1%
Discretionary Retail	HARVEY NORMAN HOLDINGS LTD	1,952,173	2%	0%	0.2%
Discretionary Retail	DAVID JONES LTD	-1,773,000	0%	-2%	0.2%
Discretionary Retail	BILLABONG INTERNATIONAL LTD	2,364,000	2%	0%	0.1%
Discretionary Retail	MYER	1,932,197	2%	0%	0.1%
Transport	QANTAS AIRWAYS LIMITED	3,447,223	4%	0%	0.3%
Transport	VIRGIN BLUE	1,710,000	2%	0%	0.0%
Transport	WOTIF	-2,953,972	0%	-3%	0.1%
Transport	FLIGHT CENTRE LTD	-550,000	0%	-1%	0.2%
Steel	BLUESCOPE STEEL LIMITED	1,047,387	1%	0%	0.2%
Steel	BRADKEN LTD	-1,335,320	0%	-1%	0.1%
Building Materials	FLETCHER BUILDING	-2,974,500	0%	-3%	0.3%
Building Materials	JAMES HARDIE INDUSTRIES NV	2,082,374	2%	0%	0.2%
Building Materials	CSR LIMITED	3,164,400	3%	0%	0.1%
Building Materials	GWA INTERNATIONAL LTD	-954,239	0%	-1%	0.1%
Paper/Chem/Agric	AMCOR LIMITED	-4,443,750	0%	-5%	0.7%
Paper/Chem/Agric	ORICA LIMITED	-1,350,000	0%	-1%	0.8%
Paper/Chem/Agric	DULUXGROUP	-2,107,500	0%	-2%	0.0%
RESOURCES AND ENERGY	20,455,207	27%	-7%	20%	26%
Diversified Miners	BHP BILLITON LIMITED	7,744,314	8%	0%	10.8%
Diversified Miners	RIO TINTO LIMITED	3,557,963	4%	0%	2.8%
Precious Metals	NEWCREST MINING LTD	3,191,958	3%	0%	2.2%
Precious Metals	ALACER GOLD GROUP	1,716,000	2%	0%	0.0%
Precious Metals	KINGSGATE CONSOLIDATED	-793,000	0%	-1%	0.1%
Precious Metals	RESOLUTE GOLD	-1,571,606	0%	-2%	0.0%
Base Metals	SANDFIRE RESOURCES	1,759,296	2%	0%	0.1%
Base Metals	INDEPENDENCE GROUP NL	1,227,600	1%	0%	0.1%
Base Metals	DISCOVERY METALS	-1,772,814	0%	-2%	0.0%
Base Metals	KAGARA LTD	1,180,951	1%	0%	0.0%
Other Resources	EXTRACT RESOURCES LTD	954,898	1%	0%	0.2%
Energy	WOODSIDE PETROLEUM LIMITED	1,636,000	2%	0%	2.5%
Energy	SANTOS LIMITED	1,485,000	2%	0%	0.9%
Energy	OIL SEARCH LTD	2,184,560	2%	0%	0.7%
Energy	AURORA OIL AND GAS	-2,045,912	0%	-2%	0.1%
SMALL CAPS	10,290,768	25%	-14%	10%	10%
CASH	11,838,299				
NET SHAREHOLDERS FUNDS BEFORE PERIOD END ADJUSTMENTS	98,561,327				
All positions as % of Shareholders Funds					

Funds Snapshot

Fund Statistics		Top 5 Holdings	
Fund NAV AUD	\$99m	Westpac Banking Corp.	8.7%
Long (67)	164%	Commonwealth Bank of Australia	8.0%
Short (36)	-76%	BHP Billiton Ltd.	7.9%
Gross Exposure	240%	Australia & New Zealand Banking Group Ltd.	7.6%
Net Exposure	88%	Westfield Retail Trust	5.5%
Cash	12%		

Portfolio Returns to June 2011

ALF	1 MONTH	3 MONTHS	1 YEAR	3 YEARS (P.A.)	SI (P.A.)
Long	-2.8%	-4.0%	26.0%	19.2%	-
Short	-4.3%	-7.9%	9.9%	1.8%	-
Gross	-1.5%	-0.6%	28.5%	26.6%	19.3%
Net	-1.8%	-1.9%	22.9%	20.5%	15.7%
Index	-2.4%	-4.8%	12.2%	-0.2%	9.2%
Net Alpha	0.6%	2.9%	10.7%	20.7%	6.5%

Monthly Net Returns

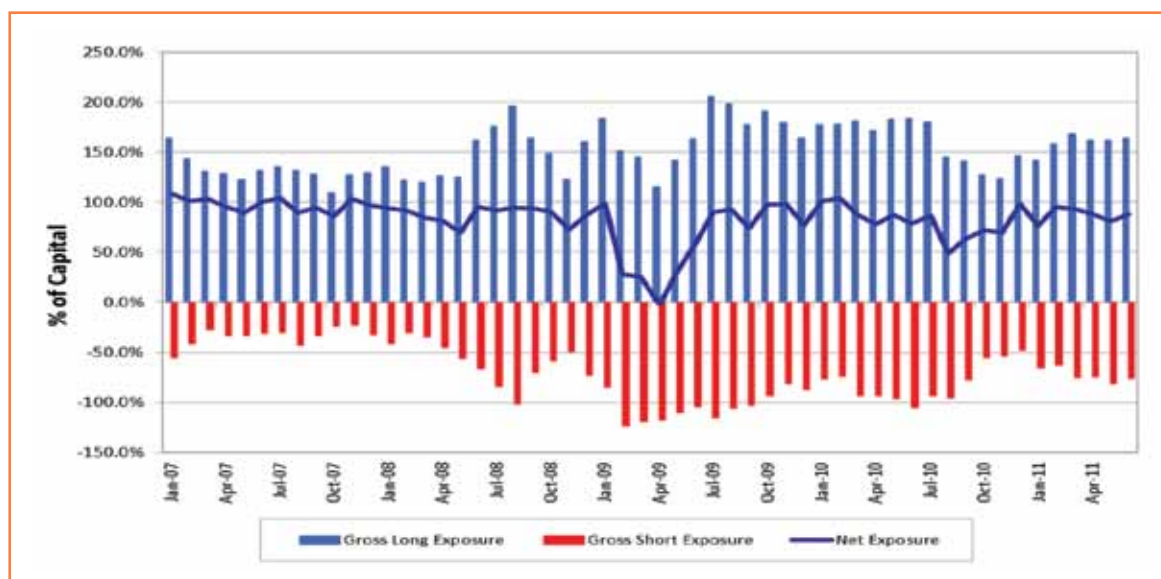
FY	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	ALF FY	INDEX
2004	-	-	-	-	-	-	-	0.4%	1.4%	0.2%	-0.0%	2.3%	4.3%	9.0%
2005	1.1%	-0.3%	4.6%	2.8%	4.4%	2.4%	0.3%	1.3%	-0.9%	-6.1%	-0.4%	4.8%	14.3%	24.7%
2006	2.0%	2.7%	4.8%	-3.0%	3.9%	3.7%	1.5%	2.0%	6.4%	2.9%	-2.1%	1.4%	29.0%	24.2%
2007	-3.2%	4.3%	1.7%	7.2%	2.8%	2.5%	3.1%	-1.6%	3.5%	1.1%	2.7%	2.0%	29.2%	30.3%
2008	-1.0%	3.4%	3.3%	1.0%	-0.3%	-1.9%	-11.5%	-8.4%	1.4%	4.4%	1.5%	-7.2%	-15.5%	-12.1%
2009	-1.3%	5.1%	-5.4%	-16.3%	-6.6%	3.0%	2.2%	2.9%	16.0%	6.7%	7.9%	7.0%	18.7%	-22.1%
2010	9.2%	12.4%	6.5%	-0.7%	0.8%	0.1%	-3.5%	2.2%	4.2%	-2.1%	-7.1%	-2.3%	19.9%	13.8%
2011	2.8%	-3.9%	2.3%	0.0%	2.7%	12.0%	2.0%	1.9%	3.6%	1.7%	-1.8%	-1.8%	22.9%	12.2%

Portfolio Exposure As Of June 2011

Sector Exposure	LONG	SHORT	NET	INDEX	ACTIVE
Consumer Discretionary	17.7%	-8.0%	9.7%	5.1%	4.6%
Consumer Staples	2.7%	0.0%	2.7%	7.8%	-5.1%
Energy	14.0%	-9.0%	5.0%	9.4%	-4.4%
Banks	28.4%	-3.0%	25.4%	20.8%	4.6%
Real Estate	13.4%	-10.1%	3.3%	6.6%	-3.3%
Other Financials	19.2%	-4.0%	15.2%	6.4%	8.8%
Health Care	10.5%	-7.6%	2.9%	3.3%	-0.4%
Industrials	20.3%	-13.1%	7.2%	7.7%	-0.5%
Materials	31.7%	-19.3%	12.4%	27.4%	-15.0%
Utilities & Telecoms	6.2%	-1.6%	4.6%	5.5%	-0.9%
TOTAL	164.0%	-75.6%	88.4%	100.0%	-11.6%

Market Cap	LONG	SHORT	NET	INDEX	ACTIVE
ASX Top 100	121.8%	-39.7%	82.1%	83.5%	-1.4%
100 - 200	18.4%	-19.7%	-1.3%	8.3%	-9.6%
Ex 200	23.8%	-16.1%	7.7%	8.2%	-0.6%
TOTAL	164.0%	-75.6%	88.4%	100.0%	-11.6%

ALF Historic Exposure





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