

Five Oceans World Fund - Wholesale

Fund report and commentary - 30 June 2008

Performance	1 month (%)	3 months (%)	6 months (%)	1 year (%)	Inception ¹ (%) p.a
Fund return (gross) [^]	-4.16	-9.32	-14.18	-15.01	-2.76
Fund return (net) [*]	-4.26	-9.61	-14.72	-16.32	-4.31
UBSA Bank Bill Index	0.65	1.95	3.80	7.34	6.88
MSCI Unhedged \$A	-8.57	-6.46	-18.17	-21.03	-7.81

¹Inception date: 3 July 2006.

[^]Gross returns assume the reinvestment of distributions and exclude the impact of ongoing management fees. No allowance is made for tax.

^{*}Net fund returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax.

Past performance is not a reliable indicator of future performance.

Market review

The quarter was a tale of two competing stories, a bear market rally followed by a further market capitulation as bad news and poor sentiment coalesced to leave the market significantly down over the period.

Through April, equity markets had continued their recovery from their March lows, which had been set following the Bear Stearns bail-out by JP Morgan, backed by the US Federal Reserve. This recovery was driven by investors hoping that we were moving back to a more traditional cycle where US rate cuts would help kick-start economic activity after the slowdown. The April rally continued with a broad move across most sectors, including the financial sector. However, by May, the rebound was losing momentum and the rally was becoming more narrowly focussed on specific sectors in energy and materials, consistent with ongoing strength in commodity prices. Financial stocks were once again falling on the back of major writedowns and rights issues. UBS, Merrill Lynch, JP Morgan, Halifax Bank of Scotland and Royal Bank of Scotland announced total writedowns of approximately US\$35bn and tapped the market for additional capital of approximately \$50bn during the quarter.

The persistent question of whether this early quarter strength marked a sustainable uptrend, or whether we were but in the eye of the storm, appeared to be answered by the markets in June as the downturn reasserted its previous trend with conviction. Overall, signs were that the global economic system continued to operate under significant stress. Lead indicators of European growth deteriorated. Inflationary pressure escalated. What became clear is that the ultimate scope of the current dislocation is still playing out.

Energy and Mining stocks were the stand out performer for the quarter, with technology the only sectors to finish up. Financials were the laggard again posting double-digit declines as writedowns and tight credit conditions continued. Most markets exhibited weakness except for Canada and Norway, on the back of their pre-eminent position in energy and resources, and Japan, which had a strong valuation-driven start to the quarter, before falling away in June.

Fund performance

The fund was down -9.6% during the quarter giving a calendar year to date return of -14.7% versus markets, as measured by the MSCI World Index in A\$ terms, which was down -18.1% calendar year to date. We commenced the quarter with the portfolio positioned on the basis that we were still in the middle of a market downturn and that what was happening was in effect a bear market rally.

Overall, the portfolio's equity exposure to the markets remained below 50% for the duration of the quarter. This defensive positioning hurt the fund during April and May as global markets rebounded strongly but assisted in mitigating losses in June as market weakness re-commenced.

Contributors to performance included Quanta Services, Varian Medical and Veeco Instruments. Our junior gold minors in IAM Gold and European Minerals detracted from performance, as did Philips Electronics, Anglo Irish Bank and Alumina Limited.

Fund activity

We remain concerned about the economic and investment outlook, and are not convinced that markets have bottomed at this point. We maintain the portfolio at a relatively low net exposure to the markets at approximately 40%, up fractionally from our position at the end of March. The portfolio is taking the opportunity to buy strong franchises at cheap valuations for the longer term but continues to hold significant cash and has hedges in place against further market weakness. Notwithstanding stock valuations prima facie look cheap, the earnings outlook, in a slowing global economy, is still uncertain and any negative company earnings revisions, or news, are being treated by the markets with disdain.

Downward pressure on economic activity in many countries has escalated. However, unlike traditional cycles the issue has not been one of excess investment capacity driving down the returns to business, but rather a shortage of it. This is what has bid up the prices of assets and caused inflation. The question is how can necessary investment now be stimulated in a world seeking to hold down inflation? Against this sits another point of irony. In this environment, late cycle capital goods expenditure should fall, but in order to reduce inflation and de-bottleneck long cycle infrastructure development, investment must be sustained. As a result, business activity will need to be sustained and supported in several important areas, yet interest rates are likely to rise. As such the market is trapped as confidence declines in late cycle stocks, but cannot be built in early cycle stocks such as financials. Hope for the rebound, born in March at the point of Fed intervention in Bear Stearns, has now faced the brutal reality check we expected.

We continue to apply our franchise driven approach with a view to adding to favoured positions in a cautious way. The key question remains "where is the bottom" and we continue to look for a capitulation event that may signal that we are through the worst.

Five Oceans World Fund - Wholesale

Fund report and commentary – 30 June 2008

Financials

Historically, falling interest rates would see the market move from a bear phase, discounting an economic downturn, to a new bull phase discounting the recovery. Market leadership would be taken by financials as a steepening yield curve would see interest spreads widen boosting financials earnings whilst late cycle stocks such as capital goods companies would still be experiencing earnings declines as business pulls back its investment. However, we are still working through the credit write-offs as the system works out its excesses. Bad debts, first seen in residential property, are now rising in commercial property. Loans to business will be next, though in this cycle corporate debt balances are relatively low. Until this phase is worked through, shares in financials will struggle to sustain any rally.

The portfolio continues to have minimal exposure to financials although we are cautiously adding to positions given the weakness. We introduced a new position in UK-based fund manager Aberdeen Asset Management following the recent sharp de-rating in its valuation despite the business carrying a relatively low level of leverage compared to other financials. It is also interesting to note that two of the larger specialist financial sector hedge funds (Toscafund & Lansdowne) now own close to 35% of Aberdeen's equity. We also added a long position in the Japanese banking sector, through Mitsubishi UFJ Financial, in anticipation that Japanese banks are one of the few beneficiaries of higher inflation and that their valuations are highly attractive.

On the positive side, steepening yield curves will widen net interest margins. Classically banks underlying profitability starts to expand at this stage of a credit cycle. Furthermore the strong banks will take significant share from not only weaker institutions, but also prospectively from investment banks as a greater portion of credit is sourced from bank balance sheets, and institutions that are highly dependent on wholesale funding are further disadvantaged. We will continue to closely monitor this unloved sector for opportunity.

Technology and Telecoms

We are witnessing continued infrastructure investment in a range of areas, from commodities to communication. Technology companies are in part being driven by the growing awareness that investment in the communications space is underwritten and sustainable over the current period. Mobile broadband is upon us. Telecom carriers are now beginning to position themselves for this next phase. Portfolio stock Intel, which has long wanted and needed to penetrate this space, announced with much fanfare a new chip architecture, whereby it inverted the focus of its technological prowess from more computing power to less power consumption. With the backing of major PC makers cheap "netbook" consumer platforms are flags as to the expectations of a major product cycle of mobile net access devices. Of course, Apple's iPhone is the highest profile, but hardly unique representative of this.

We also added to SAP over the quarter. SAP is the world's largest business software company and the world's third-largest independent software provider overall. We believe SAP is well positioned to benefit from the ongoing trend to upgraded business infrastructure.

Energy and Minerals

One of the most telling characteristics of current markets is that mining stocks in many ways have become the defensive stocks of the current cycle, whilst financials have become the most exposed. Traditionally defensive sectors are now seen as vulnerable to significant structural headwinds.

The level of commodity prices of course has reflected a fundamental shift in the source of growth in the global economy to the industrialisation of Asia, driven initially by exports to the developed world, but now increasingly by internal dynamics. We are cautious regarding this sector for a range of reasons including the increasing likelihood of a material global slowdown, the sense that commodity prices may be in a bubble, and that commodities can be seen as "hedging" two inter-related events, a weak US\$, and inflation.

The portfolio benefited from a good move in mineral sands producer Iluka while positions were reduced in junior gold miners IAM Gold and European Minerals, which are both struggling in this investment environment to make any headway.

The impacts of a high oil price and the prospect of rationing of oil are beginning to ripple through the global economy with the subtlety of a sledge hammer. Aside from the direct effects on economic activity, oil related impacts are being felt on food prices by virtue of the growing impact of biofuels, as well as oil being a crucial input into the production of fertiliser. Hence global food price inflation can be seen as significantly echoing the stresses in the oil market.

During the quarter, we took profits on Basic Energy, which had reached our target price while adding positions in US refiner Marathon Oil and global energy company, Royal Dutch Shell.

Healthcare

The portfolio has built a significant holding over time in Healthcare which has historically been a defensive sector in times of economic stress. Positions in US based companies, Johnson & Johnson, Varian Medical Systems and Zimmer Holdings have provided a level of portfolio protection in these troubled times. We added to our holding in Varian during the month.

As discussed previously Zimmer manufactures and markets products relating to orthopaedic and fracture management products while Varian is a world-wide leader in integrated cancer care systems.

Five Oceans World Fund - Wholesale

Fund report and commentary – 30 June 2008

China

Despite the many believers in the China story the onshore (A share) and offshore (Hong Kong listed) China stock markets are down over 40% and 25% respectively for the first six months of 2008. We have spent significant time over the past couple of years analysing both the global economic impact of China on the rest of the world, as well as researching investment opportunities arising from the changing nature of the region, and the shift of capital from West to East. To date we have preferred to play the “China story” through beneficiary companies listed in other parts of the world such as global miner Rio Tinto, US based electrical engineer, Emerson Electric and branded consumer goods companies such as Coach Inc.

China is today seen as the ying to the US yang. Chinese (and Indian) growth has underpinned the phenomenal growth in demand for commodities, but while growth is still robust in China, it is moderating from 10-11% annually to an expected 8-9%, as authorities tighten monetary policy to combat rising inflationary pressures. Export/import data coming out of China’s ports is starting to show a marked slowdown in growth, and the local property market is also showing signs of stress. Therefore, there is increased evidence of a slowdown in China, but data is still mixed, as this is offset by still robust infrastructure demand and fixed asset investment. As a result, the extent of the slowdown in China is currently undergoing endless debate, but it is a critical question that needs to be answered by investors, as the region remains one of the few supportive props left for the global economy.

Whilst this question is of critical importance to global investors, of almost equal importance to investors within China is the extent to which higher inflation and input costs (raw materials, wages, etc) are leading to severe margin pressure for Chinese companies. With so much of the market either Government owned, or operating within highly regulated industries, the extent to which companies can pass on costs is as much to do with government policy as it is with their own pricing power. China continues to protect and control a range of input and end user prices, e.g. oil, coal, electricity etc, which reminds investors that the government can influence the earnings level of any public company in China. This is an important point, as fighting inflation has gone to the top of the list of the Government’s priorities. Therefore, it is perhaps unsurprising that the Government has been inspired to adopt a range of policy responses that could continue to have a negative impact on local companies for some time.

In conclusion, valuations in China do look cheap versus where they stood 12 months ago, but not against their longer history. We have no investments in China, and minimal investment in Asia ex Japan at the moment, and are unlikely to re-enter until we see tangible signs of slowing inflation, lower policy risk, and some signs of a stabilisation in global risk appetite. However, there remains a select number of interesting Chinese franchises that we continue to research closely looking for valuation driven entry points.

Five Oceans World Fund - Wholesale

Fund report and commentary – 30 June 2008

Top five long positions			
	Region	Sector	Weight (%)
Alumina Limited	Australia	Materials	2.50
Intel Corp	United States	Information Technologies	2.45
AXA SA	France	Financials	2.40
Cisco Systems	United States	Information Technologies	2.29
Varian Medical Systems	United States	Health Care	2.25

Sector exposures	
	Net weight* (%)
Retailing	2.99
Banks	0.73
Insurance	3.09
Technology Hardware & Equipment	3.79
Automobile Components	3.45
Telecommunication Services	2.71
Commercial Services & Supplies	-0.19
Consumer Durables & Apparel	0.57
Household & Personal Products	2.09
Consumer Services	1.02
Energy	5.25
Materials	11.94
Capital Goods	5.99
Software & Services	3.24
Food & Staples Retailing	-0.27
Health Care & Equipment	4.81
Pharmaceuticals, Biotechnology & Life Science	3.26
Media	1.28
Semiconductors & Semiconductor Equipment	3.03
Real Estate	-2.30
Transportation	0.42
Unit Trusts	0.46
Sector / Market Hedges	-22.31
Cash and Forwards	64.95

Regional exposures			
Country Name	Long	Short	Net weight* (%)
Australia	4.15%	-1.51%	2.64%
Austria	0.40%	-	0.40%
Brazil	1.01%	-0.57%	0.45%
Canada	2.39%	-	2.39%
Finland	0.74%	-	0.74%
France	4.95%	-	4.95%
Germany	2.25%	-4.76%	-2.51%
Ireland	0.71%	-	0.71%
Japan	2.43%	-	2.43%
Korea	-	-0.63%	-0.63%
Netherlands	3.14%	-	3.14%
Norway	2.22%	-	2.22%
Spain	2.53%	-	2.53%
Sweden	0.42%	-	0.42%
United Kingdom	7.72%	-1.78%	5.94%
United States	27.50%	-12.52%	14.98%
South Africa	0.76%	-	0.76%
Grand Total	63.32%	-24.27%	39.05%

Portfolio structure	
	Weight (%)
Long positions	63.32
Short positions	-24.27
Net equity exposure [#]	39.05
Gross equity exposure [^]	87.58

*May not add to 100% due to rounding.

[#]Net equity exposure is the net equity exposure of the portfolio after short equity positions are deducted from long equity positions. [^]Gross weight is the percentage of the gross equity exposure of the portfolio. Gross equity exposure is the total of the long and short equity positions in the portfolio.

Any information contained in this publication is current as at 30/06/08 unless otherwise specified and is provided by Challenger Managed Investments Ltd ABN 94 002 835 592 AFSL 234 668, the issuer of the Fund. It should be regarded as general information only rather than advice. It has been prepared without taking account of any person's objectives, financial situation or needs. Because of that, each person should, before acting on any such information, consider its appropriateness, having regard to their objectives, financial situation and needs. Each person should obtain a Product Disclosure Statement (PDS) relating to the product and consider that Statement before making any decision about the product. A copy of the PDS can be obtained from your financial planner, our Investor Services team on 13 35 66, or on our website: www.challenger.com.au. If you acquire or hold one of our products, we will receive fees and other benefits, which are disclosed in the PDS for the product. We and our employees do not receive any specific remuneration for any advice provided to you. However, financial advisers (including some Challenger group companies) may receive fees or commissions if they provide advice to you or arrange for you to invest with us. Some or all of the Challenger group companies and their directors may benefit from fees, commissions and other benefits received by another group company.