Five Oceans Wholesale World Fund

Fund report and commentary – 30 June 2009

Performance						
	3 months (%)	6 months (%)	1 year (%)	2 years (%)	3 years (%) p.a.	Inception[1] (%) p.a.
Fund return (gross) ^	2.00	–4.71	1.90	–6.94	–1.23	–1.23
Fund return (net) #	1.69	–5.30	0.63	–8.23	–2.69	–2.69
MSCI Unhedged $A	4.03	–7.91	–15.73	–18.19	–10.23	–10.23
Difference	–2.34	+2.61	+16.36	+9.96	+7.54	+7.54

[1] Inception 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 rally that commenced in late March continued through the quarter notwithstanding we witnessed some consolidation of the gains in June. The predictable question remains whether this rally is just a technical reaction or do improvements in certain economic lead indicators, the so called 'Green Shoots', mark a trend reversal that one should heavily commit to?

From the Bulls' perspective, the authorities are continuing to underpin the financial system, while seeking to stimulate the underlying economy by contra-cyclical fiscal stimulus, plus an expansion of the government sector through infrastructure investment. Combine this with further stimulus to latent demand from underleveraged consumers in the developing world, most specifically China. Further support should come from a reversal in the inventory cycle, resulting in the rebuilding of inventories that have been run down to very low levels.

Low interest rates combined with un-orthodox measures such as quantitative easing are hoped to halt the decline in asset prices, until the recovery becomes self sustaining. Strong business franchises with internally driven growth and profit generating potential, supported by product cycles, will be attractive, as will cheap battered, but structurally sound, economically sensitive companies. Resource demand will stabilize and re-strengthen.

The Bears' dilemma is underpinned by the issue that the large debt overhang represents a tax on growth. Paying back debt out of current earnings will be a generational burden. Consumption will be seriously constrained whilst economic agents ranging from consumers to companies rebuild their balance sheets. Money supply contraction will continue to put downward pressure on asset prices risking a deflationary spiral. Renegotiating debt terms might unblock this problem but it might threaten bank solvency, and will meet with resistance from some stakeholders, particularly the banks and pension funds. This debate will come to the boil if the authorities' 'muddle through' blueprint doesn't achieve its goals. Ultimately, the key aspect to continued support for the markets will be the company earnings outlook and its associated recovery profile.

The S&P 500 finished the quarter up 15.2%, the Japanese Nikkei up 22.8% and the UK FTSE 100 up 8.23%. The Australian dollar rallied strongly during the quarter, from 69 cents to the USD up to 81 cents at quarter end.

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Fund performance

The fund was up 1.69% for the quarter which compares to the average move of global equity markets, as measured by the MSCI World Index in $A, which was up 4.03%. Over the financial year to June 30, the fund returned a positive +0.63% versus the index, which was down –15.73%.

We commenced the quarter with a net exposure to equities of 76.6% and ended the period with our exposure at 79.0%, our highest level of exposure to shares for over a year.

The main reason for the underperformance of the fund during the quarter was our continued conservatism in regard to portfolio construction, specifically the level of cash in the portfolio which held back performance as the market rallied.

Portfolio stocks that performed well during the quarter included Canadian gold miner, IamGold, US luxury goods retailer Coach Inc and technology company, Apple Inc. Detractors included Rexam Plc, AXA and GlaxoSmithKline.

The strength of the Australian dollar during the quarter affected international stock returns for the Australian based investor. Our Australian dollar positioning helped mitigate some of this impact.

Portfolio positioning and strategy

Our strategy is to monitor the range of possible system level outcomes, whilst buying a range of businesses that we believe have attractive prospects relative to the price we are prepared to pay for them. We believe stock selection will begin to re-assert itself after an extended period dominated by the macro economy. We are less interested in making calls on defensive sectors versus cyclical sectors. This further reinforces our belief that essential insights will be derived at the company level in this uncertain environment, even with respect to the unfolding of the global macroeconomic environment.

We are adjusting our risk exposures by shifting the balance of our hedging instruments, buying protection where it is attractively priced, or when our concern regarding overall systematic risk increases relative to the underlying attractiveness of the businesses in which we are invested. We believe this allows us to access attractive businesses for the longer term in the face of this complex transitional phase, whose complexity denies easy characterization and forecasting. Ultimately good businesses will prosper through this uncertainty.

Technology

Technology has been a strong performer year to date and a traditional area of focus for Five Oceans. The sector has been supported over the past few years by positive product cycles in smart phones, netbooks and flat screen TV's, despite broad consumer weakness. Ahead of us lies the potential of ultralite laptops and a corporate pc upgrade cycle driven by Windows 7 after the failure of Vista.

Technology has strong exposure to developing as well as developed economies. The China stimulus package coincided with the opening up of new 3G networks in China, and aggressive competition by the two smaller mobile phone operators in China to gain market share from the dominant player in 2G, China Mobile. This trend is stimulating demand.

Unlike at the time of the tech bubble, technology is now possibly one of the most virtuous of sectors with a number of the leading companies somewhat uniquely positioned in this GFC environment, with strong balance sheets, often large cash balances and strong cash generation, and high return on equity (ROE). This means they can continue to pay dividends, buyback stock, and undertake investments without relying on capital from financial markets, so impacted by the credit crunch. Additionally, inventories had been run down in the supply chain leading to strength in semiconductors. Some of their key customer bases also have strong balance sheets and cashflows to support investment, most notably the telecom sector, where data offerings are becoming the competitive battleground.

Defensive tech names, like portfolio stock SAP, have benefited from the resilience of their license income streams meaning that part of the sector has performed relatively well, like other defensive sectors in volatile stages of the market. SAP is the German based market leader in global business software solutions.

Another portfolio holding, Apple, sits at the epicentre, though not alone in the smart phone space. Apple has delivered strong revenue and earnings growth since the early 2000s. The latest growth product has been the game-changing iPhone. Apple recently launched the iPhone 3GS and promptly sold 1 million units in the first three days of sale. We expect global smartphone penetration to accelerate, and for Apple to gain market share. Current valuation reflects only its recent successes rather than escalating opportunities.

Financials

After the significant rally in financial stocks in March and April, May and June saw a leveling off in performance. Stocks across the sector had reached a point which balanced the perception that the financial system would not collapse, but that significant uncertainty on the trajectory of credit costs and future profitability remained. Our overall exposure to financials increased during the quarter with the portfolio exposure rising from around 10% at the end of March to 15% by the end of June.

At the beginning of May the US treasury released the results of the stress tests that had been conducted on the 19 largest US financial institutions. The tests found that an additional $74.6b in capital was needed to provide a sufficient buffer against the treasury defined advers economic scenario. In the period following the stress test announcement, it became apparent that enough confidence had been restored in the banking system as none of the banks that were required to raise capital has major issues doing so. At the same time a number of banks which were deemed not to need additional capital also raised capital in anticipation of exiting the Troubled Asset Relief Program (TARP). There is still a strongly argued view that the additional capital raised will still not be enough to survive the credit cycle, the market in general however is now comfortable with the idea that this was the last capital raise for the banks involved in the stress tests.

Over this period the markets attention shifted to the potential for commercial real estate to become a significant issue for the banking system. The stress test loss assumptions on commercial real estate were logically applied to mid sized regional banks which showed that many of them were particularly vulnerable to commercial real estate as these types of loans tended to be a much larger portion of their loan books relative to large banks. These banks are also not systematically important and so the potential for large numbers of insolvent banks became apparent. Whether this scenario eventuates will depend primarily on the developments in the commercial real estate market which we continue to monitor closely.

On the positive front we have started to receive some indications of a stabilization of credit costs in consumer lending with early delinquencies flattening out in mortgage and credit card portfolios. At this stage this may only be a seasonal affect however it is encouraging but we need to see a few more months of positive data to draw any conclusions.

We continue to own US based Wells Fargo and US Bancorp in the portfolio as, despite the rally, we believe that both stocks continue to trade at a significant discount relative to their normalized earnings power. We also believe that the current risks in commercial property will give both banks the opportunity to further expand market share against weaker players.

Commodities and energy

Commodities responded positively to supportive Chinese raw materials purchases in iron ore, thermal coal, oil and copper against an insipid export environment, leading the market to reaffirm its belief in Chinese consumption. Combined with a weaker USD and anecdotes regarding US economic stability, commodities reacted favourably. There was also clear evidence that OPEC's 4 million barrel per day production cut was being executed with an unprecedented level of compliance by its members.

The key question remains whether the emerging market restocking phase will dovetail with an OECD recovery by year end. A major gap between these two demand behemoths could pressure spot prices of metals and energy commodities back into the top end of their respective production cost curves, leading the resource equities downwards.

In particular, US gas equities rallied strongly as total drill rig count dropped over 50% in 8 months below 1,000, in a spectacular testimony of industry discipline. This is a unprecedented rate of decline in US exploration and production history. We took advantage of these early signals to add to US gas major Devon Energy. Additionally, the oil price rally forced the market to reassess the current oversupply in the offshore rig market, with sentiment improving materially as oil over $50 per barrel was seen as sustainable for the first time since the oil price trough in December last year. Portfolio holding oil services company, Noble Corp, will benefit from this dynamic through its global footprint and strong client relationships.

Asia

The economies of Asia, and in particular China have continued to show significant signs of improvement as last November's Rmb 4 trillion stimulus measures have gained traction in the domestic economy. As well as an improvement in the broad economic leading indicators like the PMI, transactions in the China property market in China have been a lot stronger than we and the market expected. Across Asia (ex Japan) credit quality has also held up surprisingly well given GDP growth in many economies is forecast to fall or has fallen below the levels experienced in the Asian Crisis. The lower leverage at both the household and corporate level suggests some of the lessons learned from the Asian Crisis in the late 1990's are putting these economies in a relatively strong position when one compares them to the developed world.

In addition, recent political events, often a source of negative surprise, have also been very positive for the region. In India, the ruling Congress Party won a surprisingly large majority in the May elections, in Indonesia, President Susilo Bambang Yudhoyono also gained a clear mandate in their elections, and there was tangible evidence of an improvement in cross-strait relations between Taiwan and China. This was reinforced by the announcement that China Mobile intended to acquire a strategic stake in Far EasTone, a leading Taiwanese mobile operator. The market now expects economic reforms will accelerate further in India, a more conducive macro & political environment will help domestic consumption in Indonesia, and in Taiwan its better relationship with China is positive on a number of fronts including better growth prospects and lower risk.

During the quarter, we introduced a position in China Construction Bank (CCB). The stock has recently been held back by the Bank of America share overhang which has now cleared, and a weak short-term earnings outlook, however we expect net interest margins will start to improve in the second half, and as a result, income growth will start to more accurately the track strong asset growth we have seen year-to-date. Despite this improving outlook CCB still looks relatively cheap on a price to earnings multiple just over 10 times, and a price to book valuation of under 2.0x for a return on equity close which looks relatively sustainable at close to 20%. CCB should perform well on a relatively attractive valuation as long as the China macro picture continues to improve.

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FIVE OCEANS ASSET MANAGEMENT

Top five long positions

	Region	Sector	Weight (%)
Rio Tinto	United Kingdom	Materials	3.19
Yum! Brands	United States	Consumer Discretionary	2.97
Procter & Gamble Co	United States	Consumer Staples	2.84
Johnson & Johnson	United States	Healthcare	2.62
Royal Dutch Shell	United Kingdom	Energy	2.33

Regional exposures

Country name	Long	Short	Net weight* (%)
Australia	1.14%	0.00%	1.14%
Canada	1.15%	0.00%	1.15%
Eurozone	0.60%	-1.92%	-1.32%
Finland	0.83%	0.00%	0.83%
France	7.00%	0.00%	7.00%
Germany	6.62%	–1.00%	5.62%
Hong Kong	1.34%	–0.48%	0.87%
Japan	2.29%	0.00%	2.29%
Netherlands	7.00%	0.00%	7.00%
South Africa	0.81%	0.00%	0.81%
Spain	2.76%	0.00%	2.76%
Sweden	0.67%	–0.56%	0.11%
Switzerland	0.87%	0.00%	0.87%
United Kingdom	11.66%	–0.60%	11.06%
United States	46.73%	– 7.85%	38.88%
Grand Total	**91.47%**	**-12.42%**	**79.05%**

Portfolio exposure summary

	Weight (%)
Long positions	91.47
Hedges and short positions	-12.42
Net equity exposure*	79.05
Gross equity exposure	103.88

Sector exposure summary

Sector name	Long	Short	Net weight* (%)
Consumer Discretionary	15.12%	–3.63%	11.50%
Consumer Staples	8.22%	0.00%	8.22%
Energy	12.37%	–1.52%	10.85%
Financials	15.56%	–0.37%	15.19%
Health Care	9.41%	0.00%	9.41%
Industrials	4.82%	0.00%	4.82%
Information Technology	11.07%	–0.51%	10.56%
Materials	6.02%	–0.60%	5.41%
Sector/Market Hedges	3.22%	–5.44%	–2.22%
Telecommunication Services	5.65%	–0.35%	5.30%
Grand Total	**91.47%**	**-12.42%**	**79.05%**

Currency summary exposure

	Weight (%)
AUD	32.10
GBP	7.15
USD	39.57
EUR	14.97
JPY	5.38
Other	0.83
Grand Total	**100.00%**

* 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 30/06/09 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 any 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.