

Portfolio changes during August and September 2011

Monthly performance to 30 September 2011

Attribution September 2011					
	1 Month (%)	3 Month (%)	1Yr (%)	3 Yr (% p.a.)	5 Yr (% p.a.)
ATI Equity Portfolio (gross of fees)	-5.0%	-11.5%	-9.9%	3.2%	2.2%
S&P/ASX300 Accumulation Index	-6.3%	-11.7%	-8.7%	-0.1%	-0.7%
Relative Outperformance	1.3%	0.2%	-1.2%	3.3%	2.9%

September 2011											
Overall attribution				Holdings				Index Attribution			
Positive		Negative		Positive		Negative		Code	Index	Attribution	Weight
NCM	0.27%	FMG	-0.38%	TLS	0.24%	FMG	-0.38%	XTL	ASX20	0.62%	9.62%
TLS	0.24%	PNA	-0.21%	NWS	0.19%	PNA	-0.21%	XFL	ASX20 to ASX50	-0.54%	-1.32%
NWS	0.19%	RIO	-0.21%	IAG	0.15%	RIO	-0.21%	XTO	ASX50 to ASX100	0.32%	-5.89%
IAG	0.15%	FGL	-0.14%	CSL	0.13%	LLC	-0.13%	XJO	ASX100 to ASX200	0.44%	-3.83%
COH	0.14%	LLC	-0.13%	MTS	0.12%	QAN	-0.08%	XKO	ASX200 to ASX300	0.15%	-2.45%
CSL	0.13%	QAN	-0.08%	Non-Holdings				Sector Attribution			
MTS	0.12%	TCL	-0.08%								
WOW	0.11%	AMC	-0.08%	Positive		Negative		Code	Sector Attribution	Attribution	Weight
PBG	0.11%	ORI	-0.06%	NCM	0.27%	FGL	-0.14%	XDK	Consumer Discretion	0.31%	2.38%
WBC	0.11%	ASX	-0.05%	COH	0.14%	TCL	-0.08%	XTK	Telecom	0.23%	2.60%
ILU	0.11%	CCL	-0.05%	ILU	0.11%	AMC	-0.08%	XFK	Financials	0.21%	5.38%
LYC	0.10%	BXB	-0.04%	LYC	0.10%	ORI	-0.06%	XHK	HealthCare	0.17%	-1.17%
ANZ	0.09%	MAP	-0.04%	PDN	0.06%	ASX	-0.05%	XEK	Energy	0.11%	-5.07%
FXJ	0.06%	TWE	-0.04%								
SUN	0.06%	GPT	-0.04%								
PDN	0.06%	STO	-0.04%								
AGO	0.05%	RHC	-0.03%								
OZL	0.05%	SHL	-0.03%								
MQG	0.04%	SGP	-0.03%								
IPL	0.04%	WDC	-0.02%								

ATI outperformed the S&P/ASX 300 Accumulation Index by 1.3% during September 2011. Several active portfolio management decisions, which were implemented consistent with the ATI process, assisted in delivering this pleasing level of outperformance, as discussed in detail below. We note that the combined level of outperformance for August-September 2011, of 0.8%, was significantly enhanced by these active portfolio management decisions. If no changes had been implemented to the portfolio since 31 July 2011, there would have been no outperformance for the two month period.

Portfolio management since 1 August 2011

The period since 1 August 2011 has been extremely volatile for both Australian and global share markets due to unresolved debt issues in the Eurozone and the US. This market volatility, or rather the macroeconomic uncertainty associated with it, has reduced our confidence in the economic outlook and its potential impacts on the individual stock earnings forecasts used within our process. This has resulted in a series of portfolio changes that have driven a reduction in tracking error towards the lower end of our targeted range.

The portfolio changes made since 1 August 2011 are best summarised as a move into more concentrated active positions in the larger cap stocks. These changes resulted from a review of each portfolio holding's balance sheet/debt profile, foreign exchange exposure and any other company specific issues the analysts' may have identified.

Portfolio changes since 1 August 2011

In summary, the process involved a review of: each portfolio holdings balance sheet position, with particular focus on timing of debt maturities, gearing levels and debt covenants; the portfolio's exposure to currencies, particularly the USD, CHF, and EUR; and other stock specific issues including corporate governance and lower US bond yields. The resultant portfolio changes are summarised as:

- Increasing the active position in the four major commercial banks to the maximum permitted level of ~8%, through increased weighting in WBC and CBA, (NAB and ANZ holdings were already at their maximum permitted levels).
- Increasing the weightings in the most attractive consumer staples stocks, being MTS and WOW.
- Increasing the exposure to domestic defensive holdings including AGK and TLS.
- Entering into a new position for CPU and increasing exposure to WES.
- Maintaining the maximum overweight position in NWS
- Exiting the positions in APN, BOQ, KCN, MGX, MQG, OST and SWM.
- Reducing the exposures to BHP, QBE and RIO.
- Moving the cash holding towards the maximum permitted level of ~5%.

Portfolio review in detail

As a result of the recent macroeconomic developments which have led to increased market volatility, ATI has made decisions since 1 August that ensure the portfolio is positioned to mitigate some of the risks which may eventuate in these market conditions.

With regard to the structural deficits in several developed nations, we conducted a review of the exposure of both ATI portfolio holdings, and potential holdings, to the US and various European economies. A review was also conducted of previous attribution in times of significant market dislocation, such as the GFC, to ensure that the portfolio was positioned to mitigate market volatility. In its simplest form, the GFC experience showed us that overweight positions in the bigger companies with dominant market positions were relative outperformers in similar market circumstances.

Our review identified that ATI's only material direct portfolio exposures to the US and European economies are NWS, QBE, LLC, CSL and NAB.

- NWS generates ~65% of earnings out of the US and ~20% UK/Europe, and was experiencing its own stock-specific issues at that time, which are discussed below.
- QBE generates ~50% of earnings from the US and ~20% from Europe and is highly leveraged to the USD, US and UK domestic bond yields.
- LLC generates ~15% of earnings out of the US and ~15% UK/Europe.
- A review of the sensitivity of CSL's business to the Swiss Franc was conducted, with the conclusion that a market weight (ie neutral) position within the portfolio would be maintained until the FY11 result was released.
- NAB does have exposure to both the US and UK banking sectors, but the core Australasian businesses still remain the key drivers.
- The portfolio has other very minor exposures to the troubled European economies such as AIX (Athens airport).

When considering the downgrade to the US debt rating, we identified three main potential impacts from the higher cost of servicing this debt burden:

- the likelihood of slower US economic growth,
- reduced flexibility for economic stimulus (QE3), and
- potential for further prolonged depreciation of the USD.

In addition to the potential impact to QBE's earnings from lower US domestic bond yields, and NWS's earnings from slowing US economic growth, the main impact we identified was the potential for higher commodity prices, particularly gold, as a result of ongoing USD depreciation. Scenario analysis was performed on NCM considering a range of potential gold prices, including one at USD1,800/oz and AUD/USD of 1.05, however the stock remained relatively unattractive even under this situation. This type of currency sensitivity analysis is a regular and ongoing feature of the ATI research process as analysts are continuously looking to stress test all portfolio and potential portfolio positions.

The major buying decisions we made over this period were:

- **Banks** – Despite the US debt downgrade and offshore macroeconomic developments, we felt that the Australian banks were still very well positioned to relatively outperform. The potential wholesale funding issues were discussed in conjunction with the ability of the major banks to continue generating excess capital in this historically low credit growth environment. We also took the view that the banks were better positioned to maintain their net interest margins via pricing power and stronger capital positions than pre-GFC. As a result, ATI moved to its maximum overweight position (8% at the GICS level) in banks and this was undertaken by moving to our maximum overweight stock positions in the relatively most attractive major banks. To reflect this thinking, the portfolio is at maximum overweight in ANZ and NAB (~6% combined) whilst WBC and CBA have slightly overweight positions (~2%).
- **CPU** – Due to its relative attractive ranking and the inherent defensive nature for much of the company earnings, we entered CPU. As the Eurozone debt concerns have increased since August, the USD has actually been rising and we felt that CPU would be a beneficiary of these translation gains. The fact that: (i) the stock had become relatively attractive; (ii) had the potential for earnings upgrades if successful in the BNY Mellon takeover; and (iii) was a beneficiary of the USD strength meant we had sufficient comfort for CPT to enter the portfolio.
- **NWS** – In light of the UK phone hacking and police bribery scandals we sought to objectively review our overweight position in NWS during a period of increased share price volatility. Importantly we tried to focus on the known outcomes, whilst also attempting to quantify the financial implications of the unknown, but possible, outcomes. In conclusion, we determined that the share price depreciation had exceeded the likely financial implications of these events, and we progressively increased our weighting in NWS to the maximum allowable position. This decision was made after determining the following:
 - i) The closure of “The News of the World” would reduce earnings by ~1%.
 - ii) The closure of all UK newspapers, were it to occur, would reduce earnings by ~3%.
 - iii) It was likely that the B SkyB takeover offer would not proceed, accordingly the potential EPS accretion from the transaction was unlikely to eventuate.
 - iv) It was likely that NWS would require management renewal and greater corporate governance controls.
 - v) While it was likely that NWS would incur potentially significant legal, compliance, and compensation costs, we believe the market would treat these as both one-off and ‘below the line’ thus not impacting longer term valuations.
 - vi) Whilst there was potential for a contagion effect across the other businesses (TV, cable) and regions (US, Australia), we believe this was extremely unlikely. On only one occasion has the FCC forced a divestment of a US television licence, which then took twenty years to occur. Further, under US anti-bribery legislation (of which there are 10-12 precedents), the prevailing penalty is a fine. For example, in the case of Siemens, the company was fined US\$800m for illegal activity associated with a government contract worth US\$13bn (which is quite a different scale to the UK police bribery allegations).
 - vii) The expected relative return for the portfolio exceeded the expected relative risk.

- **Defensive positions** – In light of our experience during the GFC, ATI decided to further increase exposures to high quality companies with strong balance sheets and transparent, predominantly domestic, earnings streams. This provided the portfolio with a more defensive bias in the case of further global equity market meltdowns. Accordingly, weightings were increased in our existing positions in **AGK, TLS, MTS** and **WOW**, while **WES** was added as a new holding.

The major selling decisions made over this period were:

The major **selling** decisions made over this period focused on stocks with company-specific issues, related to a variety of matters including commodity price and currency expectations, corporate governance, transparency of earnings, and/or balance sheet metrics, particularly the timing and quantum of debt maturities. Some of these stocks were removed from the portfolio as a risk mitigation exercise, independent of the expected return (IRR) at that point in time. A brief explanation of these selling decisions is detailed below:

- **APN** was removed from the portfolio due to both a deteriorating balance sheet position, which we deemed was likely to bring greater market focus on potential breaches of the company's debt covenants, and decreasing transparency of earnings. Any deterioration in the domestic economy was considered likely to further impact the discretionary advertising market, notwithstanding the recent impact on retailers, which was already suffering from depressed market conditions.
- **BHP** was reduced from a 3% active weight to a 1% underweight position in August. BHP still had a relatively attractive IRR based on current commodity price forecasts, however, the relative ranking of the stock reduced considerably under some scenario analysis testing, which is a regular feature of the ATI analytical process. We noted the rapid decline in global growth forecasts from economists, which contrasted with the lack of revisions to commodity price forecasts from commodity analysts. This was consistent with our observations through several previous commodity price cycles, where commodity analysts tended to be a lagging indicator of deteriorating economic conditions. After running several scenarios using different commodity prices and exchange rates, the decision was made to move BHP to an underweight position. We will continue to monitor economic conditions, commodity prices, and exchange rates, and manage the BHP portfolio position according to its relative attractiveness within the ATI investment universe.
- **BOQ** was removed from the portfolio as the share price approached a level which could possibly trigger a conversion of convertible notes into equity, significantly diluting the expected returns of other equity holders. Deutsche Bank is the counterparty to a three-tranche convertible note facility, which can be progressively converted into equity if the BOQ share price falls below certain specified levels for a period of three consecutive days. Until the BOQ balance sheet has been restructured, and the potential dilution from this exposure is removed, BOQ will not re-enter the ATI portfolio.
- **KCN** was removed from the portfolio after its relative outperformance had made the stock relatively unattractive. Similar to the BHP situation outlined above, a number of gold price and exchange rate scenarios were run to assess the sensitivity of KCN's forecast earnings as part of the ATI analytical process. In addition, our level of comfort regarding the transparency of KCN earnings forecasts was reduced following a number of company meetings between ATI and KCN. It became clear the KCN management were intent on divesting a 50% interest in their main producing asset, Chatree, to reinvest the proceeds in early stage exploration prospects, with no associated earnings. The prospect of a potential ~50% reduction in earnings within the ATI forecast period further decreased the relative attractiveness of KCN and the position was exited.

- **MGX** was removed from the portfolio because the stock failed to pass the QAS (qualitative assessment score) filter following a review by the analyst. Despite the company still being in the top quartile of ranked stocks, the deterioration in corporate governance at MGX, specifically the failure to appoint a majority of independent directors to the Board, was sufficient for the company to no longer be considered investment grade, and the position was exited accordingly.
- **MQG** was removed from the portfolio due to the rapidly decreasing transparency of the company's earnings streams. Despite the company issuing earnings guidance for FY2012, we assessed that the depressed market conditions in many of its businesses made it increasingly unlikely that MQG would be able to achieve its guidance targets. Further, the fact that the company placed such a high emphasis on a turnaround in the US market gave us increased cause for concern, in light of our comments above regarding the obvious deterioration in the US economy, limited flexibility for short term solutions and a high fixed cost structure.
- **OST** was removed from the portfolio as the relative attractiveness of the stock was reduced following negative earnings revisions post the FY2011 reporting season. Sufficient transparency of earnings for the company's iron ore operations could be reliably established, however the ATI analyst remained concerned over the earnings transparency for OST's steel business, even following a meeting between ATI and OST management. After testing a range of scenarios using different steel prices, iron ore and input prices, and exchange rates, the relative attractiveness of OST reduced to a level where a portfolio holding was no longer justified, and the position was exited accordingly.
- **QBE** was reduced to a market weight position in early August following comments from the US Fed that US interest rates were likely to remain at very low levels for at least the next two years. QBE generates ~50% of earnings from the US, with ~90% of shareholder funds leveraged to returns from US domestic bond yields. Given this explicit statement from the US Fed, and our own view that macroeconomic conditions in the US continue to decline, we made significant negative revisions to our forecast earnings for QBE, and the stock became relatively less attractive. However, after the stock fell over 25% by mid-September, we felt that the price had more than compensated for the reduction in earnings from lower US bond yields. We ran a scenario of 2.5% bond yields across all shareholder funds (including 30% European and 20% Australian Exposure) for all forecast years and used a AUDUSD exchange rate of 90c. The offsetting impact of a lower AUD in conjunction with the price fall meant that the stock was relatively attractive based on lower yields, and as such we increased the target weight to 2% (0.5% active weight).
- **SWM** was removed from the portfolio following a review of the company's quantum and timing of debt maturities. We believe that the company's high level of gearing and absolute debt levels (~\$2bn) would likely become an issue if we were to see a marked deterioration in economic conditions. The GFC showed us the ability of equity markets to become fixated with debt levels, interest cover ratios, debt covenants and illiquidity for refinancing, and the ability of short sellers to pressure companies into dilutive equity raisings.

ATI's portfolio positioning

ATI's stance on portfolio positioning since 1 August reflects a combination of the team's experience and the use of history where appropriate. We have consciously addressed the prevailing macro economic themes whilst remaining true to label as a bottom-up stock picker. A combination of intentionally being overweight selective large cap stocks and avoiding other stocks that may look relatively cheap have de-risked the portfolio and allowed ATI to navigate the last two months by generating relative outperformance.

ATI portfolio changes for the period 1 August 2011 to 30 September 2011

Stock	31 July 2011 weighting (%)	30 Sep 2011 weighting (%)	Change	Active decision
AAD	1.01	0.98	-0.03	
AGK	1.29	1.80	0.51	Increased weight
AIX	1.06	1.07	0.01	
AMP	1.47	1.55	0.08	
ANZ	8.03	8.27	0.24	Increased weight
APN	0.50		-0.50	Exited position
BHP	14.94	10.29	-4.65	Reduced position
BOQ	0.94		-0.94	Exited position
CBA	7.28	7.62	0.34	Increased weight
CPU	0.00	1.21	1.21	New position
CSL	1.40	2.79	1.39	Increased weight
FMG	1.54	2.23	0.69	Increased weight
FXJ	1.08	1.11	0.03	
IAG	2.51	2.52	0.01	
KCN	0.98		-0.98	Exited position
LLC	1.98	1.75	-0.23	
MGX	1.07		-1.07	Exited position
MQG	0.72		-0.72	Exited position
MTS	1.91	2.00	0.09	Increased weight
NAB	7.41	7.62	0.21	Increased weight
NWS	2.63	3.05	0.42	Increased weight
OST	1.21		-1.21	Exited position
PBG	1.02	1.05	0.03	
PNA	1.00	0.75	-0.25	
QAN	2.53	2.11	-0.42	Reduced position
QBE	2.96	1.90	-1.06	Reduced position
RIO	5.74	4.72	-1.02	Reduced position
SUN	1.99	2.43	0.44	
SWM	0.90		-0.90	Exited position
TLS	5.83	6.84	1.01	Increased weight
WBC	6.21	8.37	2.16	Increased weight
WES	1.08	3.72	2.64	Increased weight
WOW	4.04	5.40	1.36	Increased weight
WPL	2.08	1.85	-0.23	
Cash	3.66	5.00	1.34	Increased weight