

Challenger Asian Share Fund

Managed by Five Oceans Asset Management

Fund report and commentary – 30 June 2010

Performance					
	Quarter (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Inception (%) p.a.
Challenger Asian Share Fund					
Fund return gross ^	1.94	14.68	-3.64	8.53	8.99
Fund return net #	1.37	12.16	-5.80	6.13	6.58
MSCI All Country Asia ex Japan Index, unhedged in A\$	3.39	16.89	-1.73	8.81	8.35
Challenger Wholesale Asian Share Fund					
Fund return gross ^	1.92	14.68	-1.69	9.75	10.16
Fund return net #	1.65	13.47	-2.74	8.59	8.99
MSCI All Country Asia ex Japan Index, unhedged in A\$	3.39	16.89	-1.73	8.81	9.31

^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.

The Fund changed investment managers, investment methodology and benchmarks on 9 November 2009. The benchmark shown above combines the old benchmark (MSCI All Country Far East Free (ex-Japan) Accumulation Index (unhedged) for the period prior to 9 November 2009 with the current benchmark as detailed above for the period since 9 November 2009 p.a.

Fund performance

The Fund was up for the quarter but underperformed the average move of regional equity markets, as measured by the MSCI AC Asia ex Japan Index in \$A, which was up 3.39% during the June quarter. We commenced the quarter with a net exposure to equities of approximately 95.0% and ended the period with our exposure little changed at 94.7%.

Currency volatility was again a big feature of the quarter as the Index in local terms fell -2.81% with foreign currency exposure providing a hedge against this weakness for the Australian based investor. The Australian dollar fell -8.0% against the US dollar during the quarter from 92 cents to 84 cents as investors sought the relative safe haven currencies such as the US Dollar.

Markets were clearly operating in a risk-averse manner with defensive sectors such as Telecoms, Utilities and Consumer Staples outperforming. The initial market euphoria from the widening of the Renminbi (RMB) trading bands in mid-June quickly dissipated as growth concerns both in China and globally weighed on the market.

In local market terms over the June quarter there was a very wide range of returns in the region. Positive returns came from Indonesia (+4.0%), and India (+1.1%). The weaker markets included Taiwan (-8.2%), Hong Kong (-5.5%), and China (-4.2%). The China A share market which is largely closed to foreign investors fell a further -22.9% continuing the negative returns since the A share market peaked in August 2009. India and Indonesia have been the exceptions as the long-term growth stories are very much in tact despite these markets traditionally being very sensitive to global risk appetite. ASEAN markets in general (Thailand, Philippines, Malaysia, Singapore as well as Indonesia) outperformed as they are generally less correlated and less well owned than the markets in North Asia.

In a difficult quarter, the best performing stocks in the portfolio were Hyundai Mobis, China Mobile, Genting Berhad, Want Want China Holdings, Jardine Matheson and Daphne International. Detractors included Taiwan technology positions including Acer, MediaTek, and Hon Hai and consumer discretionary stocks, Esprit and Skyworth Digital as well as property stocks, Henderson Land and KWG Property Holdings Ltd.

Portfolio positioning and strategy

Equity markets were weak through the quarter as investor expectations of a global recovery, which had been high coming into the quarter, were dented by further deterioration in the European banking system, weaker than expected economic data from the US and early indications of slowing Chinese growth.

Specifically, leading indicators of improving global growth appear to have peaked in April, and are now suggesting decelerating global economic growth in the second half of 2010. Moreover, this slowdown appears to be occurring across all regions. While nothing is yet pointing to another recession for either Europe or the US, (the so called 'double dip'), the deceleration in growth is suggestive of a lower economic growth trajectory than is typically evident post a recession.

Our bottom-up company analysis continues to drive sector and portfolio positioning. The Fund continues to have significant exposure to the Consumer Discretionary, and Information Technology sectors, while remaining relatively less exposed to defensive sectors like Telecoms and Utilities. Our strategy is to continue to target a range of businesses that we believe have attractive prospects relative to the price we are prepared to pay for them. We are particularly focussed on stock selection as we continue to move further away from the depths of the crisis.

In terms of portfolio changes we introduced new positions to the portfolio in the form of Singapore based lender DBS Group, South Korea based flat screen maker LG Display, and Indian education provider Educomp Solutions. During the quarter we sold out of KB Financial Group, CIMB Group, and Powertech Technology to help fund these new positions. We added some hedging around a few specific stock positions in the portfolio during the quarter but at the overall portfolio level the net invested position remained largely unchanged.

Macroeconomic

Within China a raft of measures were announced by the State Council in mid-April relating to the property sector, including increasing the down payments for homes, suspending loans for third home purchases, and increasing mortgage rates on second homes.

To some extent this is positive that the Chinese authorities are trying to head off a more significant and destructive bubble forming in the China property market. This can partly be seen as counter-cyclical tightening as the authorities in China attempt to get "ahead of the curve", unlike what happened in the US housing market before 2007! The policymakers' preference in China for administrative measures over monetary ones tends to give a higher degree of policy flexibility to unwind their tightening efforts in order to help avoid a hard landing in the economy.

Following on from the property tightening, China's June macroeconomic indicators, including the manufacturing PMI, have started to exhibit a moderation in China's growth momentum. China's PMI index came in at 52.1 in June down 1.8 points from May. However, it is still much higher than the 38.8 it reached in November 2008 (above 50 is an expansion in activity level / below 50 is a contraction in activity level). As a result, the consensus GDP growth rate for China of 9.2% for this year is in the process of being downgraded.

The headline GDP growth in the second quarter continued to be robust at 10.5% year-on-year albeit a significant deceleration from the 11.9% seen in the first quarter. Inflation for the moment also seems to be under control as the authorities try to engineer a "Goldilocks" type scenario. The headline CPI inflation in the second quarter moderated to 2.6% year-on-year following a surprise decline in CPI inflation to 2.9% in June (from 3.1% in May). This gives us confidence that a managed China slowdown is being orchestrated.

The property sector in China as well as the A shares have been a good lead indicator into the recent market weakness. Other cyclical sectors like materials, coal, and autos followed the property sector down over May and June. At the more micro level China's growth seems to be decelerating across a range of products (e.g. Automobiles, LCD TV's, etc) as May and June's month-on-month sales are showing slowing momentum. The difficult balancing act for the authorities is how to manage the slowing off the economy to control inflation without killing longer term economic momentum within a highly problematic global environment.

Wage pressures, as evidenced by recent labour strikes, are an additional risk variable as they will continue to impact the margins of many manufacturers in China as labour and consumption takes a greater share of China's growing economic pie. Longer term, higher wages and a stronger Chinese currency will continue to drive the transformation of the region from one dominated by exports to one when the economy is better balanced between domestic consumption and external trade.

While most of markets focus remains on China, Taiwan also garnered market interest with the signing of the Economic Co-operation Framework Agreement (ECFA) between China and Taiwan in Chongqing in June. This is seen as an important milestone in cross-strait ties and positive for Taiwan's long-term competitiveness. Much like the Closer Economic Partnership Agreement (CEPA) with Hong Kong, the ECFA increases Taiwan's integration with China's economy. Taiwan's central bank (CBC, the Central Bank of the Republic of China) also raised interest rates by 12.5 basis points in late June but given this was an increase from 1.25% to 1.375% it was far less material to the market's eyes than the signing of the ECFA.

Energy and Materials

Commodity prices faded from their peak in late April, as concerns over the combination of European deflation, US growth and Chinese post stimulus slowdown raised questions about global demand for minerals and energy.

Within minerals, nickel, copper and iron ore all posted sizeable price falls. The Fund took advantage of this weakness to add a position in Xstrata PLC. Xstrata is a global minerals producer engaged in key base metals and coal markets: copper, coking coal, thermal coal, nickel and zinc. Despite the obvious risks in China's growth rebalancing away from fixed asset investment Xstrata possesses a strong portfolio of production growth located in low risk global domiciles. Xstrata's markets remain tightly balanced, inventories are low, and even small demand growth rates should be enough to maintain strong pricing. Xstrata's valuation is well supported on a price-to-earnings ratio of 6x (on 2010 estimates) against a global peer group on 11x despite Xstrata's superior growth profile.

Our holding in Korean steel maker POSCO, was weak over the quarter as steel demand slowed in China and leading steel makers cut prices on the mainland. This has the potential to squeeze margins industry wide if there is not an associated fall in iron ore and coal costs. Chinese steel prices are expected to fall further in August, and are now close to cash costs. POSCO is relatively more insulated as its main demand industries such as auto and home appliances (45% of revenues) are still growing. Given the industry risks POSCO is now trading back towards book value, and at a discount to replacement cost despite its through the cycle return on equity (15-20%) consistently being above its cost of equity given POSCO's very competitive cost structure.

Technology

Information Technology underperformed the region in the quarter, after a very strong 2009, as doubts about world growth hit all economically sensitive sectors, technology included. The technology sector fell -11.6% in local terms with Technology Hardware and Semiconductors particularly weak. The demand outlook for a range of technology products (iPad, smartphones, etc) seems to remain supportive but elsewhere the picture on demand (e.g. LCD TV's, netbooks, semiconductors, etc) and inventories have turned more uncertain. The market is now questioning the sustainability of consumer demand, though our analysis suggests corporates are still locked into a long deferred PC upgrade cycle.

Taiwanese portfolio holdings MediaTek (semi-conductors) and Acer (PC manufacturing), were weak over the quarter. MediaTek was affected as a result of the overall short-term deceleration in Chinese growth and particularly following a regulatory crackdown on whitebox (generic) handsets. As a result, MediaTek reduced its second quarter revenue guidance with the market pricing in the risk of also missing third quarter guidance. Additionally, Acer was affected by its high exposure to the weak European economies with 40% of its sales coming from the region. Despite Acer facing a number of challenges in some of its key markets we continue to like its market share and margin improvement story long-term.

Electronic components manufacturer, Hon Hai was also weak as labour issues related to the "Foxconn suicides" garnered significant global press attention, and highlighted important ESG issues for the company. Hon Hai announced a series of wage hikes for its factory workers in June, but still faces the risk of orders being cut by key clients like Apple. However, no other contract manufacturer has the scale or (non-labour related) cost advantage of Hon Hai as it has acted quickly to shift production to inland China. We did reduce exposure to Hon Hai and Acer during the quarter and continue to monitor the ongoing performance of these companies.

The Fund added to its position in Digital China during the quarter as the Chairman (Guo Wei) increased his stake in the business by buying a 9.8% stake from Legend Holdings for US\$135 million. With its leading PC distribution and IT services businesses, Digital China is in an interesting position as China starts to rebalance away from the "physical economy" and more towards the "knowledge economy". In terms of sales at the margin the fund reduced its position in Taiwanese based components distributor, WPG Holdings as the company approached our target price.

The Fund added LG Display during the quarter. LG Display is the number 2 player in TFT-LCD manufacturing after Samsung Electronics with an estimated 17% market share. LGD has a strong market position from which to benefit from the industry's new product cycle including LED and 3D TV's. It is also the key supplier of screens for Apple's iPad. While there are earnings risks in LGD given the industry's high cyclicality we believe they are largely priced in with the stock trading at 1.1x Book Value but potentially generating a return on equity of 15-20% if estimates are not significantly downgraded. We sold out of Powertech in Taiwan to help fund the position in LG Display.

Consumer

A number of China consumption proxies, excluding China automobile sector, continued to perform well during the June quarter. From an overall perspective the more defensive Consumer Staples sector was up during the quarter, while the Consumer Discretionary was down mainly due to its high weighting towards the auto stocks. For the longer term, extending the autos and home appliances subsidy programs, raising workers' minimum wages, and letting the Renminbi currency gradually appreciate are all supportive of consumption growth and demand in China. As a result of these positive trends the sector and in particular China consumption beneficiaries continue to be well owned and highly favoured by investors. We remain wary of some of the very high valuations placed on these stocks.

The Fund added Educomp Solutions, India's largest education services company during the quarter. Educomp enjoys a dominant market share in key segments of the fast-growing but hugely under serviced private education market in India. The stock has been weak following the announcement of disappointing FY10 earnings and concerns that increasing competition and growth shifting to rural towns would lead to a decline in profitability. However, our research and discussions with the company suggest the last year's profit miss was driven by higher than expected losses on new investments which ultimately should contribute to long-term earnings growth. The core business (Smart Class) continues to perform ahead of expectations. We initiated a position with Educomp trading on 15x forward-earnings, representing a discount of more than 50% from its historic average level. This looks attractive given Educomp's leadership position and the significant long-term secular growth potential of the Indian education market which is projected to continue growing at 15-20% p.a.

At the margin the Fund also added to Korean discount and department store operator Shinsegae to take advantage of a short-term share price correction. The stock had been weak after the company reported a worse than expected decline in operating profit margins (as part of its newly focussed everyday low price strategy at its discount stores) and as investors were disappointed with the lack of a positive share price reaction to the successful listing of Samsung Life in which Shinsegae holds a significant stake. We felt the market was overly focussed on short-term data and were encouraged by the favourable consumer response to its pricing strategy as seen in its same store sales growth. At the time we added to our holding the stock was trading at less 11x earnings representing a discount of more than 20% against its global peers.

To help fund new positions profits were taken across a range of strong performers including Daphne International, Want Want China, and Jardine Matheson although all of these stocks are still held in the portfolio

Financials

The Financial sector was caught in the quarterly market down draught, with weakness led by real estate stocks. Concerns over the China property market also spilled over into Hong Kong given mainland buyers are now estimated to represent up to 20% of the luxury residential market in HK. Somewhat surprisingly the China Banks were reasonably defensive over the quarter, with China Construction Bank actually up 1.3%, despite the continuing concerns on credit quality and capital raising across the China banking sector and of course the liquidity overhang from the US\$20 billion Agricultural Bank of China (ABC) initial public offering (IPO).

ABC is the last of the big four state-owned banks to list in Hong Kong / Shanghai. Like the other China banks an investment in ABC is an investment in China's economic growth prospects, however, as its name suggests ABC comes with a particular skew towards the rural sector. While rural banking has higher growth (under-banked, less competition), and a better margin profile, it also has a higher cost of distribution and a higher credit risk profile, yet compared to its peers the company reports a lower credit provision ratio and its returns on assets (un-gearred profit) are lower. For these reasons we find ABC's valuation at comparable levels to peers as unattractive, and thus the fund chose not to participate in its IPO.

Over the quarter we started to add a position in China Everbright and Ping An Insurance within the financials sector. China Everbright is a financial services conglomerate backed by the Everbright Group. Its key asset is its 33.3% stake in Everbright Securities which represents approximately 65% of its net asset value. China Everbright is the only HK listed vehicle with significant exposure to the China A share market activities through Everbright Securities. The introduction of index futures and margin financing in the A share market should help boost volumes. China Everbright also owns a stake in China Everbright Bank which is expected to IPO in the A share market later this year.

Over the quarter we started to add a position in Singaporean bank DBS, as Singapore's economy is undergoing a sharp recovery as highlighted by the recent announcement of second quarter GDP growth of 19.3% year-on-year boosted by the opening of the two new casinos. GDP growth of 18.1% in the first half of 2010 is the strongest half since records began in 1975. We view DBS as a key beneficiary from Singapore's growth through higher loan growth, rising margins and currency appreciation.

We also believe the new CEO (Piyush Gupta) will be disciplined on any M&A opportunities since the market has viewed acquisition risk at DBS as very high. DBS trades at 1.3x Book Value against past growth cycles which has seen the stock trade between 1.5-2.4x Book Value. To help fund the new positions we sold out of Hang Lung Group, KB Financial, and CIMB Group, and reduced the position in Dah Sing Financial.

The major detractor from performance in the June quarter was the Fund's real estate holdings including Henderson Land, Kerry Properties, and Cheung Kong.

Telecoms & Utilities

As traditionally defensive sectors, Telecoms and Utilities were relatively strong during the quarter. From a stock-picking perspective we struggle to find attractive growth opportunities within the Telco and Utilities sector within the Greater China region and we remain wary of the continued regulatory risk as pricing / tariff regimes, particularly in the China power sector, are generally more opaque than elsewhere in the world. The Fund's position in China Mobile performed well over the quarter with the company up 3.9%.

Portfolio holding Bharti Airtel, was one of the few telecom stocks to underperform as it had another tough quarter with a number of negative newsflow events. After Bharti was impacted late in the March quarter by the announcement of its dilutive and rather expensive US\$9 billion acquisition of Zain in Africa, weakness continued with the high price paid for spectrum in India's 3G auction (costing Bharti US\$2.7 billion), and the sceptre of growing regulatory risk with the regulator looking to introduce higher 2G licence renewal costs. The ongoing price war in the Indian cellular market with 12 operators fighting for market share continues to impact Bharti's revenues.

However, we find it interesting that despite "the perfect storm" of negative news Bharti's remains an attractive proposition for the portfolio trading on a significant discount to the Indian market for what remains a good long-term franchise. Our assessment is that Bharti is now so under-owned by the market it only needs the newsflow to get less bad for Bharti to perform better. Since the end of the quarter there are signs that tariffs are now starting to stabilise in India, management will start to give more detail on the integration benefits from acquiring Zain, and regulatory risks could get watered down with the involvement of the Finance Minister.

Outlook

Overall, we are in a difficult environment, but one where there will be winners and losers, so we will continue to focus on our stock selection to identify those companies that have emerged from the crisis intact and with strong prospects for market share gains and cash generation over the period ahead.

Top ten long positions			
	Region	Sector	Weight (%)
Samsung Electronics	Korea	Information Technology	3.37
Reliance Industries	India	Energy	3.04
Infosys Technologies	India	Information Technology	2.90
Jardine Matheson Holdings	Hong Kong	Industrials	2.71
Cheung Kong Holdings	Hong Kong	Financials	2.70
Genting Berhad	Malaysia	Consumer Discretionary	2.58
Petrochina Co	China	Energy	2.56
Kasikornbank PCL	Thailand	Financials	2.56
China Construction Bank	China	Financials	2.52
Banpu PCL	Thailand	Energy	2.52

Country exposure summary			
Country name	Long (%)	Short (%)	Net (%)
South Korea	16.54	0.00	16.54
Hong Kong	19.54	-0.58	18.96
Taiwan	9.94	0.00	9.94
China	20.40	-0.49	19.91
Thailand	5.08	0.00	5.08
India	13.63	0.00	13.63
Indonesia	3.85	0.00	3.85
Malaysia	3.40	0.00	3.40
Philippines	1.10	0.00	1.10
Singapore	2.04	0.00	2.04
Other	0.24	0.00	0.24
Grand total	95.76	-1.07	94.69

Sector exposure summary			
Sector name	Long (%)	Short (%)	Net (%)
Consumer Discretionary	13.21	-0.49	12.72
Consumer Staples	5.76	0.00	5.76
Energy	10.32	0.00	10.32
Financials	28.08	-0.58	27.50
Health Care	0.00	0.00	0.00
Industrials	6.82	0.00	6.82
Information Technology	22.43	0.00	22.43
Materials	4.69	0.00	4.69
Telecommunication Services	4.45	0.00	4.45
Utilities	0.00	0.00	0.00
Index	0.00	0.00	0.00
Grand total	95.76	-1.07	94.69

Portfolio exposure summary	
	Weight (%)
Long positions	95.76
Short positions	-1.07
Net equity exposure ²	94.69
Gross equity exposure ³	96.83

Currency exposure summary	
	Weight (%) ¹
AUD	9.95
GBP	0.01
HKD	37.09
IDR	3.86
KRW	17.23
MYR	3.60
PHP	1.10
SGD	2.06
THB	5.07
TWD	10.35
USD	9.67
Grand total	100.00

¹ May not add to 100% due to rounding.

² Net equity exposure is the net equity exposure of the portfolio after short equity positions are deducted from long equity positions.

³ 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.

100PercentInvesting (Altitude Private Wealth Pty Ltd)

Phone: 03 8621 0900

Email:
enquiry@100percentinvesting.com.au

www.100percentinvesting.com.au

AFSL: 299536

Any information contained in this publication is current as at 30/06/10 unless otherwise specified and is provided by Challenger Managed Investments Limited ABN 94 002 835 592 AFSL 234 668, the issuer of the Funds. 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 PDS 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.