

Challenger China 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 China Share Fund					
Fund return gross ^	-0.48	7.49	-1.30	17.58	17.19
Fund return net #	-1.05	5.06	-3.55	14.88	14.47
MSCI China Index – unhedged	1.93	7.05	1.22	18.72	17.15
Challenger Wholesale China Share Fund					
Fund return gross ^	-0.47	7.51	-1.31	N/A	11.18
Fund return net #	-0.78	5.96	-2.61	N/A	9.78
MSCI China Index – unhedged	1.93	7.05	1.22	N/A	12.94

^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 underperformed the benchmark for the quarter, as measured by the MSCI Golden Dragon Index in \$A, which was up 1.93%. We commenced the quarter with a net exposure to equities of approximately 96.7% and ended the period with our exposure marginally lower at 93.2%.

Currency volatility was again a big feature of the quarter as the MSCI Golden Dragon Index in local terms fell -5.6% 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 adverse 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.

Over the June quarter the Greater China markets underperformed the Asia ex Japan region. In local market terms Taiwan was down -8.2%, followed by Hong Kong down -5.5%, and China down -4.2%. The China A share market which remains largely closed to foreign investors fell a further -22.9% continuing the negative returns since the A share market peaked in August 2009.

In a difficult quarter, the best performing stocks in the portfolio were China Mobile, WPG Holdings, Want Want China Holdings, Jardine Matheson and Daphe International. Detractors included energy related stocks including China Shenhua and China Coal Energy Co. Additionally, Taiwan technology positions including Acer, MediaTek, and Hon Hai detracted as did consumer discretionary stocks, Esprit, Skyworth Digital, and AirMedia.

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, whilst 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 China financial conglomerate China Everbright, China based insurer Ping An Insurance, global luxury goods maker LVMH, and global minerals producer Xstrata. During the quarter we sold out of Hang Lung Group and French luxury goods conglomerate PPR 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 of 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 where the economy is better balanced between domestic consumption and external trade.

Whilst most of market’s the focus remains in 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 a 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. For these reasons, energy and materials were amongst the weakest performing sectors during the second quarter. Portfolio positions in China Shenhua and China Coal Energy Co were notably weak.

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.

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. MediTek 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.

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 LVMH to the portfolio as we view Louis Vuitton as the pre-eminent luxury brand in China. LVMH now generates 28% of revenues in Asia ex Japan (with China its largest market), and this number excludes Asian tourists buying LVMH products in other locations (e.g. in Europe, US, etc). Given its growth rate in Asia is over twice the rate of the Group overall, Asia is soon expected to overtake Europe (32% of revenue) as LVMH’s largest market. Goldman Sachs estimates that China will become the world’s largest luxury market by 2018, and could be a US\$328 billion market by 2025 (an estimated 15 times larger than the current market). LVMH is significantly cheaper than a number of local China consumption stocks, and has a more assured long-term market position given the lack of any local luxury brands in China.

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. Detractors from performance in the June quarter were the Fund’s holdings in Esprit and Skyworth Digital.

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. Through its holding in Everbright Securities, China Everbright is the only HK listed vehicle with significant exposure to China A share market activities which are expected to benefit from the introduction of index futures and margin financing in the A share market in the near future.

We also added a position in Ping An Insurance, China’s second-largest life insurer and second-largest Property & Casualty insurer, after the recent fall in the A share market and its acquisition of Newbridge’s stake in Shenzhen Development Bank. Ping An has interesting long-term exposure to China’s income growth and rising insurance penetration where core premium growth should continue to grow at around the 15-20% level especially with further pension reform, and investment liberalisation. To help fund the new positions in the sector we sold out of Hang Lung Group.

The major detractors from performance in the June quarter were the Fund’s real estate holdings including Henderson Land, Kerry Properties, and Cheung Kong.

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 (%)
China Construction Bank Corp	China	Financials	4.41
China Mobile	China	Telecommunication Services	3.95
Cheung Kong (Holdings)	Hong Kong	Financials	3.87
Petrochina Co	China	Energy	3.61
BOC Hong Kong (Holdings)	China	Financials	3.59
Taiwan Semiconductor Manufacturing Co	Taiwan	Information Technology	3.26
Acer Inc	Taiwan	Information Technology	3.10
Jardine Matheson Holdings	Hong Kong	Industrials	3.06
China Petroleum & Chemical	China	Energy	2.94
Henderson Land Development	Hong Kong	Financials	2.83

Country exposure summary			
Country name	Long (%)	Short (%)	Net (%)
China	42.00	-0.69	41.31
Hong Kong	30.06	-0.95	29.11
Taiwan	17.15	0.00	17.15
Other	5.72	-0.12	5.60
Grand total	94.93	-1.76	93.17

Portfolio exposure summary	
	Weight (%)
Long positions	94.93
Short positions	-1.76
Net equity exposure ²	93.17
Gross equity exposure ³	96.69

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.

Sector exposure summary			
Sector name	Long (%)	Short (%)	Net (%)
Consumer Discretionary	18.29	-0.61	17.68
Consumer Staples	3.29	0.00	3.29
Energy	9.62	0.00	9.62
Financials	34.88	-1.15	33.73
Health Care	0.00	0.00	0.00
Industrials	4.36	0.00	4.36
Information Technology	20.29	0.00	20.29
Materials	0.25	0.00	0.25
Telecommunication Services	3.95	0.00	3.95
Utilities	0.00	0.00	0.00
Index	0.00	0.00	0.00
Grand total	94.93	-1.76	93.17

Currency exposure summary	
	Weight (%) ¹
AUD	2.27
EUR	0.10
GBP	0.03
HKD	70.74
TWD	17.45
USD	9.41
Grand total	100.00

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