

Merlon Australian Share Income Fund

Fund performance and commentary – 30 June 2010

Performance ¹		3 Month (%)	1 Year (%)	2 Years (%) pa	3 Years (%) pa	Inception ² (%) p.a.
Yield*	Merlon Australian Share Income Fund ³	3.2	8.9	8.7	9.8	10.0
	S&P/ASX200 Accumulation Index ⁴	0.9	5.3	6.1	5.9	5.6
Total return*	Merlon Australian Share Income Fund	-8.1	11.1	1.0	-5.1	4.6
	S&P/ASX200 Accumulation Index	-10.9	14.4	-3.5	-6.4	6.6
Volatility ⁵	Merlon Australian Share Income Fund		12.8	15.3	14.5	12.1
	S&P/ASX200 Accumulation Index		17.5	20.2	19.0	16.0

*Yield and return data stated after fees and grossed up to include value of franking credits (Fund franking credits: 1 month: 0.2%, 3 months: 0.5%, 1 year: 2.1%, 2 years: 2.6% p.a., 3 years: 2.6% p.a., inception: 2.6% p.a. Market franking credits: 1 month: 0.1%, 3 months: 0.2%, 1 year: 1.3%, 2 years: 1.5% p.a., 3 years: 1.4% p.a., inception: 1.3% p.a.).

View on markets

Having rallied initially, markets again turned sharply to finish the month lower. The market's correction from its April peak has seen financial year returns diminish to 13.1%, a far cry from what had been implied in January. Ultimately, it was macro risk rather than corporate recovery that was the dominant theme for the year and June was typical of this thematic, with markets focused on European sovereign debt concerns, regulatory uncertainty through the morphing of the RSPT into the MRRT, and political instability as evidenced by the historic first term change of Prime Minister. All of these factors have served to overshadow stock level factors, with the outcome being entrenched volatility rather than recovery.

Performance

The Fund outperformed during the month. Performance was assisted by exposures to Metcash, Telstra, Coca-Cola Amatil and Centennial Coal. Also supporting relative returns for the month was the portfolio's net hedging levels, albeit at lower than historical levels, which is a function of our stock level valuation assessments showing that while the market appeared fairly valued, few stocks appeared overvalued. The environment is such that the timing (not just the magnitude) of earnings is affecting short term valuation metrics and hence is becoming a key driver of stock returns. Detracting from relative returns were underweight exposures to the gold sector and overweight exposures to Fairfax, Qantas and Macquarie.

Outlook

Arguably, equity markets were the key drivers of policy during the GFC. Now, in the early stages of the economic recovery,

policy appears to be increasingly driven by bond markets, a transition symbolic of where the debt and hence the most apparent risks lie. Critics of fiscal austerity measures (and specifically the timing) point to the lack of a sufficient period of healing before implementing what is essentially contractionary economic policy. These concerns have been given greater weight with evidence that the roll off of fiscal measures implemented during the global financial crisis are now being seen in US employment and residential markets.

We have also seen the effect of Chinese tightening measures in key commodity markets, with the spot price of iron ore declining from a peak above USD180 to below USD130. This decline in the key steel making input came as the market began to look back on April's 670mt annualised steel production rate as being a peak, and further exacerbated on some indications that stockpiles have begun to rise and steel prices falling.

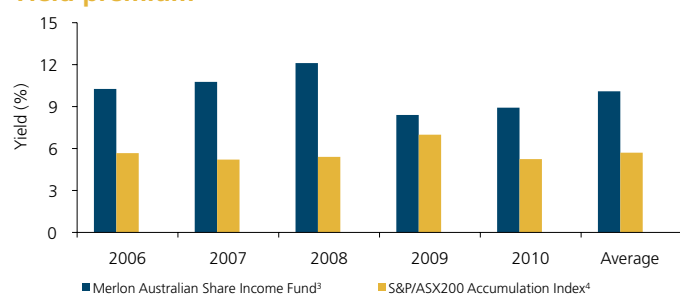
Strategy

While not previously appearing necessarily overvalued, stocks are now appearing quite attractive from a fundamental valuation perspective. However, tempering this attractiveness will be the inevitable 'pushing out' of the anticipated recovery timeframe currently factored in by markets, particularly as current earnings growth expectations reasonably strong and may prove difficult to beat.

Our approach provides us with the ability to prudently hedge holdings where shorter term valuations have moved beyond that justified by short term expectations (despite demonstrating longer term upside), while maintaining exposure to those we believe offer the ability to consistently generate sustainably high and growing cashflows to equity holders.

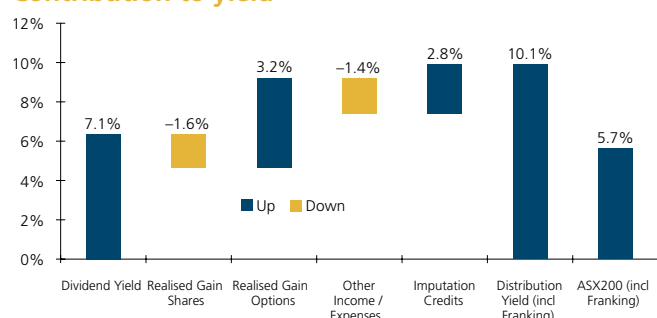
Asset allocation ⁶		
	Current (%)	Range (%)
Securities	74.3	60–100
Hedging ⁷	22.4	0–40
Cash	3.3	0–10

Yield premium



Top ten exposed positions as at 30 June 2010		
	Exposed weight (%)	Active weight (%)
Westpac Banking Corporation	6.66	0.39
Telstra Corporation Limited	6.63	3.04
Commonwealth Bank of Australia	6.60	-0.86
Australia and New Zealand Banking Group	5.92	0.49
National Australia Bank Limited	5.27	0.38
BHP Billiton Limited	5.13	-7.40
Westfarmers Limited	4.44	1.15
Rio Tinto Limited	2.75	-0.13
Suncorp-Metway Limited	2.14	1.13
Tatts Group Limited	1.89	1.61

Contribution to yield⁸



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Footnotes:

- Past performance is not a reliable indicator of future performance. Net fund returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax.
- Wholesale inception date: 30/09/2005.
- Yield (total investment income) excludes the effect of reinvestment and represents the sum of dividend yield, realised capital gains relating to ordinary investment management activity, and fees and expenses. Calculated as distributions paid divided by average daily fund net asset value. Assumes investor is tax resident in Australia.
- Calculated as dividends paid divided by daily market capitalisation of S&P/ASX 200 Accumulation Index. Source: IRESS
- Volatility measured as standard deviation of monthly returns. Not calculated for periods less than 12 months as statistically not reliable.
- May not add to 100% due to rounding. Reduction in market exposure in some sectors as a result of granting call options and purchasing put options in respect of holdings in the portfolio.
- Derivative hedges over securities.
- 3 years, percent, per annum, inclusive of imputation credits.

Disclaimer: Any information contained in this publication is current as at 30 June 2010 unless otherwise specified and is provided by Challenger Managed Investments Ltd ABN 94 002 835 592 AFSL 234 668, the issuer of the Merlon Australian Share Income Fund ARSN 089 715 926 (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 the 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 133 566, 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 planners (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 Challenger group companies and their directors may benefit from fees, commissions and other benefits received by another group company.

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