



# Ironbark Karara Investment Funds

## Quarterly Investment Report

December 2011

**For the quarter ended 31 December 2011, the Ironbark Karara Australian Share Fund and the Ironbark Karara Australian Small Companies Fund outperformed their respective benchmarks**

### Market Review

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#### Contents

#### Market Review

Global developments continued to dominate the December quarter. The S&P/ASX 300 Accumulation Index recovered some of the previous quarter's loss, rising 2.3%. This narrowed the benchmark decline to -11.0% over the calendar year.

Markets remain gripped by the interplay of developments in Europe, China and the US. The extreme risk aversion that emerged in the September quarter moderated slightly, however the emergence of new pressure points in Europe tempered some positive developments in the US and China.

#### Portfolio Performance & Activity

The major highlight of the quarter was US economic data, which was unequivocally better than expected, with evidence emerging that the economy recovered momentum in the second half of 2011 as the earlier impact of the Japanese earthquake and higher gasoline prices reversed. US corporate earnings continued their robust expansion and look to have finished the year up around 17% above 2010. The S&P 500 rose 11.2% over the quarter, with cyclical sectors performing most strongly.

#### Key Contributors & Detractors

The Chinese economy slowed as the government policy measures to control inflation and cool the housing market continued to bite, increasing concerns it is vulnerable to weakening external demand. However, commodity markets recovered some ground over the quarter as a series of announcements showed the government focus has clearly shifted back towards a pro-growth bias. Nevertheless the Chinese stock market closed 2011 down 20% for the year and 58% below the level it ended 2007.

#### Asset Allocation

The European crisis, however, continued to morph as sovereign debt pressures spread further into 'core' Europe. Italian bonds yields capitulated above the critical 7% level and there were downgrades to the credit ratings of Hungary, Poland and Belgium. France was placed on negative credit watch by the major ratings agencies.

#### Top Holdings

Policy responses were eventually hammered out which included larger 'haircuts' to Greek debt, expansion of the European Financial Stability Fund and agreement (with the exception of the UK) on a new framework for fiscal budgetary discipline. New governments in Italy, Greece and Spain introduced austerity measures and promised labour market reform. Bank liquidity concerns moderated as the European Central Bank (ECB) and other central banks took broad ranging measure to shore up bank funding. These moves all suggest progress, however Germany and the ECB continued to keep the pressure on by resisting pressures for broad based quantitative easing or mutualisation of debt. European equities recovered a little (Euro Stoxx 50 rising 6.3%) but markets remained deeply pessimistic that European governments will have both the will and the mandate to deliver on their promises.

#### Market Outlook

The Australian 10 year bond continued to be a substantial beneficiary of the European crisis. Its yield dropped a further 55 basis points to a record closing low of 3.67%. Over the past six months the 10 year bond yield has collapsed by 1.5% as Australia has moved quickly up the pecking order of sovereign credit quality. This also put a floor under the Australian dollar which rebounded 5.7% against the US dollar to USD1.02, ending the year almost unchanged.

Very soft core inflation data saw the Reserve Bank of Australia (RBA) reduce its forward CPI forecast from 3.25% to 2.50% and cut the cash rates by 0.25% in November. This was the first rate cut in eleven quarters and it was followed by a further 0.25% cut in December. The cash rate starts 2012 at 4.25% with markets pricing at least three additional cuts to come.

Gold softened again as the better US data reduced the immediate prospects of another round of quantitative easing.



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## Quarterly Investment Report

December 2011

### Portfolio Performance & Portfolio Activity

#### Ironbark Karara Australian Share Fund

The Fund delivered a return of 3.19% (net) over the December quarter, bettering the S&P/ASX300 Accumulation Index return of 2.05% by 1.14%.

While the market rose in the quarter the underlying trend was mixed with ongoing negative earnings revisions, downbeat corporate news and continued caution. At the margin investors continue to demonstrate strong preference for the defensive areas of the market. Best performing sectors over the quarter were the high yield Telecoms (7.0%) and Utilities (8.3%) sectors. Metals and Mining was the weakest sector, falling 3.8%.

These general trends remained a headwind to the Fund which has a bias to a range of inexpensively valued companies that stand to prosper against a global economic backdrop that exhibits modest, but positive, momentum. Notwithstanding this, the Fund outperformed its benchmark thanks to strong stock selection.

A key contributor to performance was News Corporation (10.1%). The company's USD5billion buyback program is now half completed. Our rationale to increase the Fund's holding in the company at the height of the News

### Performance as at 31 December 2011

#### Ironbark Karara Australian Share Fund

	Net Fund Return (%)	Benchmark <sup>^</sup> (%)	Excess Return (%)	
<b>Fund size:</b> \$24.0 million				
	1 month	-1.58	-1.44	-0.14
	3 months	3.19	2.05	1.14
<b>Exit Price:</b> \$ 1.0365	6 months	-10.29	-9.83	-0.46
	Financial year to date	-10.29	-9.83	-0.46
	1 year	-10.68	-10.98	0.30
<b>Inception date:</b> 30 June 2005	2 years (pa)	-5.69	-4.57	-1.12
	3 years (pa)	7.02	8.32	-1.30
	4 years (pa)	-7.77	-6.70	-1.07
	5 years (pa)	-3.27	-2.22	-1.05
	Since commencement of Fund* (pa)	3.13	3.75	-0.62

#### Ironbark Karara Australian Small Companies Fund

	Net Fund Return (%)	Benchmark (%)	Excess return (%)	
<b>Fund size:</b> \$62.0 million				
	1 month	-4.20	-4.30	0.10
	3 months	2.13	-0.60	2.73
<b>Exit Price:</b> \$ 2.1556	6 months	-7.91	-12.32	4.41
	Financial year to date	-7.91	-12.32	4.41
	1 year	-9.46	-21.43	11.97
	2 years (pa)	5.46	-5.75	11.21
<b>Inception date:</b> 30 June 2005	3 years (pa)	21.80	11.83	9.97
	4 years (pa)	0.79	-10.04	10.83
	5 years (pa)	7.53	-5.18	12.71
	Since commencement of Fund* (pa)	15.56	2.42	13.14

Net performance figures are calculated using exit prices, net of fees and reflect the annual reinvestment of distribution.

Retail investors should refer to net returns. If investing through an IDPS Provider, the total after fees performance return of your investment in the Fund may be different from the information in this report.

\*This figure represents the annualised performance of the Fund since inception.

<sup>^</sup>The S&P/ASX 300 Accumulation Index was adopted as the Ironbark Karara Australian Share Fund's performance benchmark on 1 July 2010.

Benchmark calculations prior to this date are based on the S&P/ASX All Ordinaries Index.



# Ironbark Karara Investment Funds

## Quarterly Investment Report

December 2011

### Ironbark Karara Australian Share Fund (continued)

of the World scandal in July was that the likelihood, going forward, that the company would act to deploy its substantial balance sheet capacity in shareholder-friendly ways. This thesis appears to be playing out.

Downer EDI (11.5%) contributed positively to performance. Over the quarter four Waratah trains were accepted into service by the NSW urban rail authority, RailCorp. We anticipate progress in relation to the Waratah's reliability and project financing over the next couple of months. While these developments will not entirely de-risk the Waratah project, they should provide a level of comfort that the worst of this problematic contract is behind the company.

The Fund continued to benefit from excellent contributions from its small cap holdings, with good gains from Aurora Oil & Gas (51.3%), Silver Lake Resources (17.2%) and Saracen (10.3%).

Energy sector stock selection also added value. The Fund's holding in Oil Search rose 10.4% as it reaffirmed progress of the PNG LNG project and the oil price recovered back towards USD100/bbl. The Fund's nil holding in Woodside (-5.7%) added to relative performance. Woodside fell as new management continued to temper its predecessor's optimistic expectations of production growth.

Detracting from performance were the Fund's small exposures to the retail sector. JB Hifi (-25.7%), Myer (-5.2%) and Harvey Norman (-12.7%) were marked down after JB Hifi, Kathmandu and Billabong downgraded expectations after experiencing tough trading conditions in the run up to Christmas. The thesis on the retail sector has been that while the sector is experiencing both cyclical and structural headwinds, the cyclical headwinds should ease. Thus far we have been disappointed by the time it has taken for the expected normalisation to occur.

The Fund increased its exposure to Leighton Holdings, ANZ Banking Group, BHP Billiton and Macquarie Bank. Against this, the Fund reduced its exposure to recent strong performers Brambles, Ansell, Wesfarmers and also QBE Insurance and Incitec Pivot.

The Fund increased holdings in Leighton Holdings following an encouraging first quarter update. We expect the company will emerge more profitable than investors expect as its loss making contracts are completed in the coming year.

Incitec remains a key overweight, however fertiliser prices appear to have peaked and we expect a quiet few quarters in the lead up to the commissioning of their new explosives plant next year.

The Fund increased its underweight to Wesfarmers as we do not believe the good progress being made at Coles Supermarkets is sufficient to mitigate the prospect of rising competition and diminishing returns across a number of its other businesses.

One company that the Fund does not hold but is watching closely is Computershare. Contrary to our expectations the company won regulatory approval in November to acquire its largest US competitor BNY Mellon. The price paid appears reasonable and Computershare should stand to benefit from substantial costs savings over the next two years as the businesses are combined. Unfortunately this good news was partly offset by a substantial profit downgrade. This is consistent with our view that the company still has some way to go before its earnings fully trough.

Finally, on a corporate governance note, one highlight during the quarter was the introduction during the Annual General Meeting (AGM) season of the Government's so-called "two strikes" rule under which successive votes against a company's remuneration report brings on a spill of a company's board. This has brought investor attention squarely onto a feature of remuneration reports that has long been our key focus and is the long term incentive structures for senior management. We believe that appropriately structured long term incentive payments are critical for ensuring that senior executives are motivated in a way that promotes value creation for shareholders. Recent government legislative changes have heightened the receptiveness of company boards to engage with us on this important issue.



# Ironbark Karara Investment Funds

## Quarterly Investment Report

December 2011

### Ironbark Karara Australian Small Companies Fund

The Fund rose 2.13% (net) during the three months to December. This constituted 2.73% of outperformance when compared with the benchmark S&P/ASX Small Ordinaries Accumulation Index return of -0.60% for the quarter.

At a sector level the strongest contributors to Fund performance were overweight positions in Consumer Discretionary and Industrials, while an underweight position in Metals & Mining also contributed to performance. Overweight positions in Information Technology and Telecommunication Services detracted.

At a stock level the major contributors to Fund performance were Aurora Oil & Gas (51.3%), Silver Lake Resources (17.1%) and Campbell Brothers (19.7%) while a nil holding in Medusa Mining (-34.7%) also contributed to relative performance. The major detractors to performance included overweight positions in Red 5 (-18.2%), SMS Management & Technology (-16.4%) and an underweight position in Karoon Gas (58.2%).

During the quarter the Fund topped up existing positions in Super Retail, Automotive Holdings, Fleetwood, Beach Petroleum, Saracen Minerals and Alacer Gold, as well as establishing a position in Flight Centre. These purchases were funded from cash reserves and by selling down positions in Silver Lake, Saracen and by exiting positions in Cobar Consolidated and CSG.

Flight Centre is an Australian-based global travel agent with over 1,500 stores and 6,400 staff around the world. Although the company operates predominantly in Australia, Flight Centre sells airfares, car hire, accommodation, cruise products and holiday packages in 10 countries. The company is a beneficiary of low Australian unemployment and a high AUD, both of which have been significant drivers of overseas travel over the past 18 months.

### Market Outlook

Progress has been made towards resolving the Euro-zone debt crisis, however the issues are complex and far reaching. We expect European governments to continue to iterate towards credible plans for tackling debt and improving productivity. The appointment of technocrat governments in Greece and Italy is progress to this end. We look forward over the coming quarter to seeing the detail of the promised labour market reforms critical to improving Europe's long term competitiveness.

There will be turbulence before correct policy settings are in place and, in the meantime, Europe has in all likelihood already entered recession. We do not expect markets to take the pressure of the Euro area until this

### Top 5 Holdings as at 31 December 2011

#### Ironbark Karara Australian Share Fund

Security Name	Sector	% of Fund
BHP Billiton Ltd	Materials	12.6
National Australia Bank Ltd	Financials	9.6
Australian & New Zealand Banking Group	Financials	7.8
Rio Tinto Ltd	Materials	5.9
Westpac Banking Corp.	Financials	4.6

#### Ironbark Karara Australian Small Companies Fund

Security Name	Sector	% of Fund
Ramsay Health Care Ltd	Healthcare	4.4
Ausdrill Ltd	industrials	3.9
Mineral Resources Ltd	Industrials	3.9
Silver Lake Resources Ltd	Materials	3.6
Aurora Oil & Gas Ltd	Energy	3.6



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## Quarterly Investment Report

December 2011

### Key Contributors & Detractors

#### Ironbark Karara Australian Share Fund

Top 5 Contributors	Active Position
Newcrest Mining Ltd	Underweight
Wesfarmers Ltd	Underweight
National Australia Bank Ltd	Overweight
News Corp	Overweight
Downer EDI Ltd	Overweight

Top 5 Detractors	Active Position
JB Hi-Fi Ltd	Overweight
Commonwealth Bank of Australia	Underweight
Rio Tinto Ltd	Overweight
Iluka Resources Ltd	Underweight
Telstra Corp Ltd	Underweight

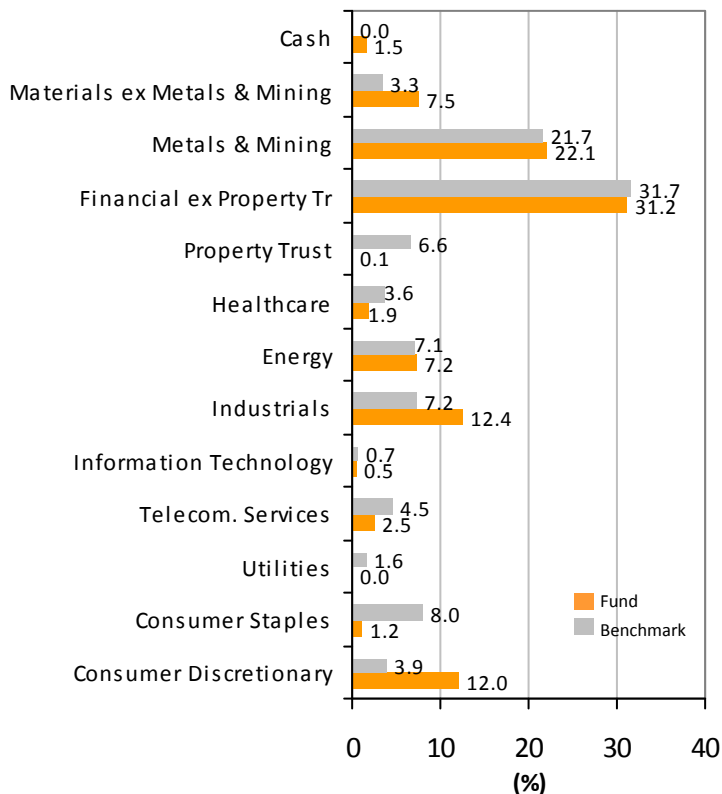
#### Ironbark Karara Australian Small Companies Fund

Top 5 Contributors	Active Position
Aurora Oil & Gas Ltd	Overweight
Silver Lake Resources Ltd	Overweight
Campbell Brothers Ltd	Overweight
Medusa Mining Ltd	Underweight
PanAust Ltd	Overweight

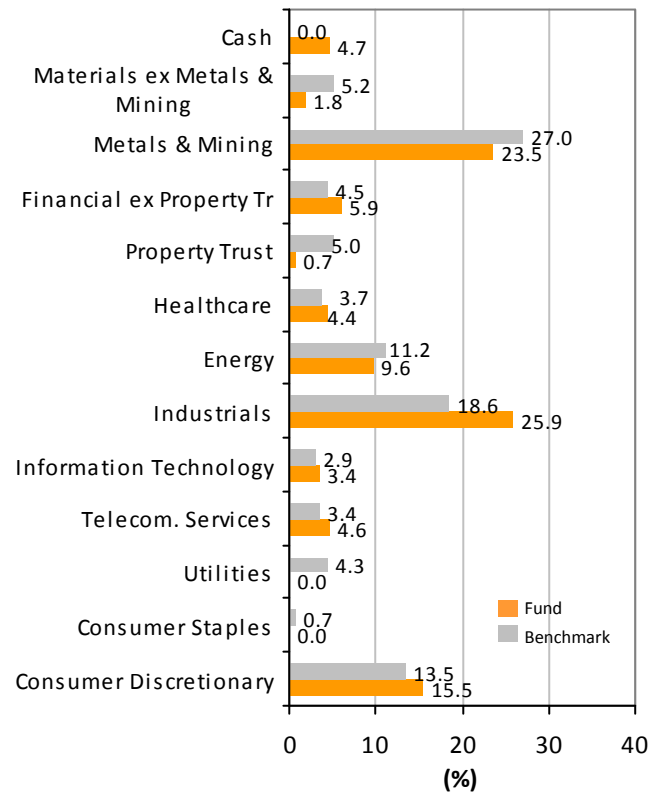
Top 5 Detractors	Active Position
Red 5 Ltd	Overweight
SMS Management & Tech Ltd	Overweight
Karoon Gas Australia Ltd	Underweight
Flinders Mines Ltd	Underweight
Peet Ltd	Overweight

### Asset Allocation as at 31 December 2011

#### Ironbark Karara Australian Share Fund



#### Ironbark Karara Australian Small Companies Fund





# Ironbark Karara Investment Funds

## Quarterly Investment Report

December 2011

### Market Outlook (continued)

new found commitment to reform has been delivered upon and internal tensions moderate. But, as fiscal disciplines are put in place, we would expect the Germans and the ECB to become more accommodative.

The US is entering a pre-election phase that promises little bi-partisan progress on fiscal initiatives before the election in November. The US economy continues to show solid momentum but the recovery remains undermined by its depressed housing market. We are now seeing the pre-conditions for recovery starting to fall into place and expect to see some improvement in 2012 that will help offset inevitable government fiscal tightening.

Australia, as one of the least-indebted developed economies and with a small and shrinking deficit, is well-placed relative to developed world peers to weather any near-term turbulence. We believe the domestic economy remains relatively well positioned given strong linkages to faster growing developing nations and their demand for nation building commodities over the medium to long term.

The Reserve Bank of Australia (RBA) starts 2012 with significant scope to stimulate domestic economic activity via further cuts in official interest rates. Australia's new found position up the global credit quality pecking order may enable the RBA to maintain lower interest rates than would historically have been possible.

Stock markets are acutely attuned to changes in global growth expectations. But when looking at market returns over a given period the valuation starting point is the most significant single determinant of future returns.

Although earnings in 2011 did not match the start of the year's expectations we expect earnings per share growth of around 12% over the calendar year. Given the market's decline this amounts to an estimated 28% de-rating of the market vs. last year's starting point. Even with modest improvement in 2012 earnings, equities look uncommonly attractive vs. bonds and history.

Our view reflects this starting point that is, considerable pessimism is factored into share prices. In many cases the market continues to price many high quality companies near global financial crisis lows, despite now exhibiting both lower and better structured debt, as well as a demonstrated ability to respond proactively to difficult operating conditions.

While investors ride out any short term market gyrations, they can take comfort from solid corporate balance sheets and attractive dividend yields.

### Important information

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