dfs advisory services

update

Quarterly Newsletter December 2012

Written 31 Jan 2013

2012 Year in Review

DFS has had a busy 12 months to 31 December 2012. We are pleased that we managed to complete a number of significant projects to further enhance our service offering :

i) Transition to the Dollar Fee arrangement (DFSMA).
ii) Introduction of the Risk Profile Models (DFSMA).
iii) Model restructures in September 2012, following the Investment Team's 6 monthly review which took into account market volatility and risk management in the portfolios.

SuperWrap Platform Transition – an Update

An area which is still in progress is the transition of our BT SuperWrap clients to a new platform. This has taken longer than anticipated because of issues arising during our due diligence and negotiations with potential platform providers. In summary, our search for a replacement super platform seeks the following objectives :

- **Access to a wide investment menu** which includes all funds in the DFS Models. This is the **key driver for the proposed change of platforms**. As you know, Wrap clients have been unable to optimise their portfolios as many of the DFS Model Managers are not available on the investment menu. This has created variances between the 2 platforms. Furthermore, Wrap clients are also not able to benefit from the Risk Profile Model automatic rebalancing functionality.
- **Competitive pricing: Because** DFS has a **very** competitive fee structure with BT Super**Wrap, the alternative platform options to date** have been more expensive. We remain confident that we can secure an arrangement at similar pricing levels, but with access to better functionality and investment menu options (per the first dot point).

A balance between the above is the key to finalising our due diligence. We will keep you updated.

Cash Review

Several managed funds paid distributions for the December 2012 quarter. A large majority of the distributions have been received in cash; hence the current cash balance is higher than usual for many accounts.

Our Administration Team will review clients' funding requirements for the next 6–12 months (pension payments, fees) and set aside liquid funds accordingly. **If you have a need for additional funds over the coming months (for which we have not previously been made aware), please notify Adele Henry as soon as possible.** Having adequate cash levels is critical for minimising the risk of redeeming investments at an inopportune time—as redeeming at a low point can have a significant adverse effect on overall portfolio returns. Where the cash review identifies a need to redeem so as to top up low cash balances, the current market rally provides a good opportunity to do so.

Indicative Outlook – Forward Cash and Fixed Interest Rates

The recent volatility in financial markets has also cast greater emphasis on indicative future cash yields as part of our portfolio management.

The table on the following page lists the expected yields from the various defensive asset class models. The Defensive portion of portfolios is largely comprised of fixed interest investments and provides stable income flows to portfolios.

Investment ($100,000 to $250,000)		Term (Mod. Duration)	Current Yield/ Rate NET OF MERs Indicative Only	Date of Update
Base				
11 am cash rate			3.00%	31-Jan-13
Bank Bill		40 days	3.07%	31-Jan-13
Cash				
Adelaide Bank CMA			2.50%	28-Jan-13
HSBC Working Cash			2.55%	31-Jan-13
Macquarie True Index Cash Fund	MAQ0789AU	47.45 days	3.08%	31-Dec-12
UBS Cash Fund	SBC0811AU	47.45 days	3.06%	31-Dec-12
Term Deposits				
Adelaide Bank Term Deposit (30D)		30 days	3.70%	28-Jan-13
Adelaide Bank Term Deposit (90D)		90 days	4.25%	28-Jan-13
Adelaide Bank Term Deposit (180D)		180 days	4.30%	28-Jan-13
Adelaide Bank Term Deposit (365D)		365 days	4.25%	28-Jan-13
Managed Funds				
Sovereign Bond Model		5.40 years	3.54%	31-Dec-12
Diversified Credit & Fixed Income Model		3.03 years	6.47%	31-Dec-12
DWS Diversified Income Fund #	DAM0012AU	9.48 months	3.65%	31-Dec-12

Assumes nil returns from macro (alpha) strategies

More information on expected yields for your portfolio (defensive and growth assets) will be included in your next formal annual Review Report.

SMSF Member Records – Impact on Planning Strategies and Estate Planning

As the name suggests, Self-Managed Super Fund (SMSF) legislation puts the responsibility on trustees to maintain proper records of member benefits—including the tax components. This is typically done by the trustee-appointed Accountant during the preparation of financial accounts each year-end.

Unlike data on member balances and transactions during the year, information on the tax components is not required to be reported each year in the ATO annual return. Unless trustees utilise the services of a Specialist SMSF Accountant, this could be an area of potential exposure. Often the lack of information is a hidden issue until such time as the information is required. Typically, this information is shown on the member's annual statements. **We encourage you to check your SMSF member statements and, if the tax components are not reported, enquire with your SMSF Accountant as to whether this information is maintained elsewhere in their database.**

From a planning perspective, tax component information is critical when advising on strategies such as Withdrawal/Recontribution, Transition-to-Retirement (pre age 60) and Estate Planning—to name just a few. Where there is uncertainty on what the taxable component of the member balance is, it becomes difficult to optimise such strategies. Furthermore, making an erroneous assumption could result in an inadvertent breach of the Superannuation legislation or an incorrect tax calculation. The above is more relevant for clients aged 55–60 where withdrawals are prima facie taxable to the member. Although clients aged ≥60 are eligible for tax-free withdrawals, the tax component of their benefits still requires planning as this may impact their estate planning strategy.

Super News Update

As you may have read recently, various newspapers have reported on the suggestion that the federal government is considering reintroducing a limit on tax-free superannuation payouts, imposing an exit tax on funds carrying balances close to $1 million. Understandably, this has caused concerns among many self-funded retirees who have built their own retirement assets (paying 15% tax during the accumulation phase) in order to generate their own tax-free pension income to provide for their retirement lifestyle. Against a background of current concerns about Australia's insufficient retirement savings (given its ageing population), this proposal seems to go entirely against the grain. Several Superannuation Industry bodies echo this view and we expect high level debate and discussions to follow. We will keep you informed of any relevant updates.

Accessing DFSMA Online Reports

As with Wrap reports, DFSMA reports are available online via : dfs.managedaccounts.com.au

Username: This is generally your full name eg: adelehenry
Password: You would have been initially issued with a temporary password which you would have changed when you first accessed your account. If you have forgotten your password – simply type your user name in and then click on the forgotten password link. You will be sent an email within 24 hours with a link that will enable you to update your password and access your account.

Should you require any assistance please contact the DFS Administration Team.

dfs portfolio solutions update

Quarterly Investment Newsletter: December 2012

DFS Commentary & Outlook

2012 was another year in which investors had their confidence in the global economy sorely tested. Although the year started on a reasonably upbeat note after the initiatives taken by the European Central Bank at the end of 2011, investors soon started to worry again about a double dip recession in the US, a hard landing in China and a break-up of the Eurozone. As if this were not enough, the year also saw:

- elections and referenda in several countries including the US, Japan, Holland, Greece, Ireland and France;
- the change of government in China and ongoing political unrest in the Middle East;
- a sharp drop in commodity prices; and
- Hurricane Sandy and the approaching “fiscal cliff” in the US;

2012 In Review

The commentary below is provided by Caravel Consulting, a non-institutionally aligned firm specialising in macroeconomic analysis. Caravel Consulting has been appointed to the DFSPS Investment Advisory Committee to support part of our Asset Allocation process.

Pessimism reached a peak in the June quarter when several signals were flashing red at the same time. In particular, although the US labour market was looking better, manufacturing activity was getting weaker. In China, inflation was falling, but so was activity and the authorities seemed tardy in responding with new policy stimulus. Worst of all, the failed Greek election in May and the need for a new election the following month, plus the likelihood of a change of government at the French elections, led to intense speculation that the Eurozone would be unable to survive the year. The escalating Spanish banking crisis added to these worries.

In the face of these concerns it is hardly surprising that equity markets had a rocky first half of the year as investors priced in systemic risks on top of doubts about assets depending on global growth, such as resource stocks. Instead investors turned to safety through government bonds, or income through higher yielding assets such as equities paying high dividends, corporate bonds, emerging market debt and distressed debt. Some of these high-yielding assets have been bought so aggressively that they now appear expensive relative to other assets and the underlying economic fundamentals. US high yield and Australian corporate bonds are two examples of this.

One of the questions debated extensively in 2012 was whether bond markets have become a bubble waiting to burst. We are inclined to think that despite yields on government bonds being at record low levels, they are not a bubble in the strict sense of the term. In particular, yields on government bonds at the moment still relate in a reasonably sensible fashion to the level of interest rates and the pace of economic activity around the world. True, yields at these levels do not represent good value compared with other assets, but that does not necessarily make a bubble. However, we cannot be quite so charitable about some non-government bonds. The high yield and corporate bonds mentioned above are not only expensive, they are also well out of line with the fundamentals. This puts them at much greater risk of capital losses when investor sentiment changes.

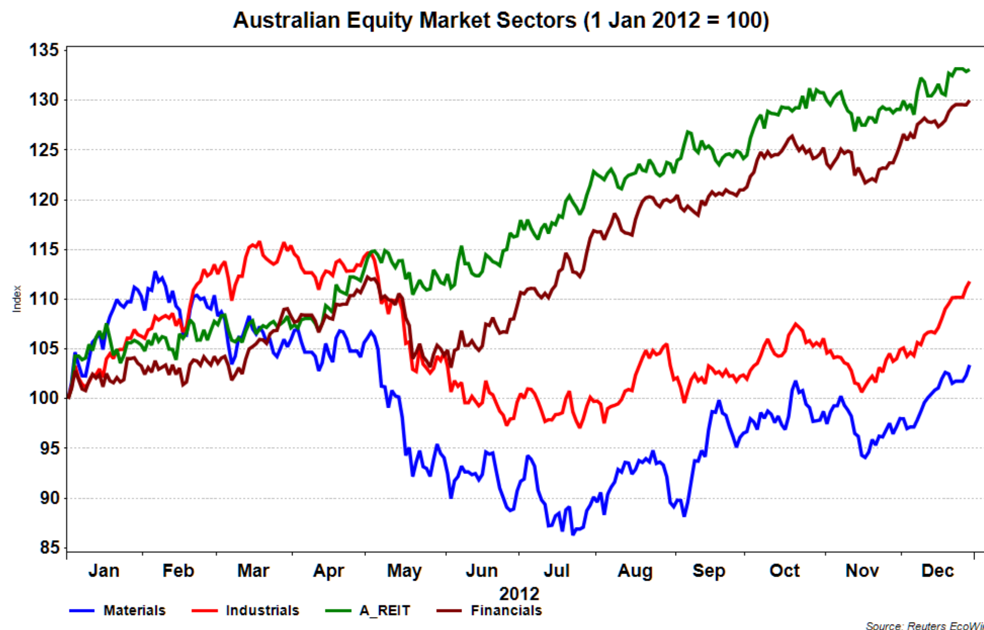
The second half of 2012 illustrated how investor sentiment can swing from one side to another. Despite all the dire predictions about the Greek elections and the Spanish banking system, the Eurozone did not fall apart. Once again, global investors misread the resolve of the Europeans to make the system work, even in the face of massive difficulties, and the ability of the ECB to do what it takes to keep the system together. Global investors also misread the situation in China where the leading indicators of economic activity did not support the pessimistic “hard landing” scenario that caused so much concern.

There is a broader theme at work behind these events. Over the past year or so investors have been sceptical about the effectiveness of government policy. On the one hand huge budget deficits and national debts have been shown to be unsustainable and on the other hand the massive injections of liquidity by central banks seem to have been slow to have the desired effects. This, plus the residual pessimism hanging over from the GFC seem to have led investors to adopt the “glass half empty” attitude noted by Reserve Bank Governor Glenn Stevens.

Global investors may now be starting to see past this overly cautious view, which would bode well for growth assets in the coming year. The second half of 2012 saw some significant developments which displayed both the resolve of the policy-makers and the efficacy of their actions. These included:

- further monetary policy stimulus programs by the central banks of the US, the UK and China;
- a change of economic policy in Japan after the election in December with a focus on more monetary stimulus and weakening the yen;
- further interest rate cuts in Australia;
- significant improvement in the US housing sector and further declines in measures of unemployment;
- China avoided the so-called hard landing and is now posting better-than expected growth figures;
- inflation has yet to become a problem, despite warnings to the contrary from some commentators.

To be sure, there are still problems facing the world economy, of which more in a moment, but overall, investors became too bearish in 2012. As the second half of the year unfolded equities outperformed bonds, although the preference for high yield and defensive equities remained. The chart below shows the relative performance of selected sectors in our equity market over the past year.



The sustained outperformance of REIT’s and financials is very clear. The A-REIT sector rose more than 30% in 2012, and financials were not far behind. In contrast, materials and industrials struggled for most of the year as commodity prices fell, the high $A hurt manufacturing industry and the Federal government’s pursuit of a budget surplus acted as a drag on the economy.

The extent of the slowdown in the Australian economy has become much more apparent in recent months. Consumer and business confidence is soft, the unemployment rate has probably fallen as far as it will, growth of national income has slowed sharply and the end of the mining boom suddenly looks a lot closer than previously thought. In the face of these and overseas pressures, the Reserve Bank cut interest rates four times in 2012 from 4.25% to 3.0% which is as low as rates fell in the GFC. Despite this, the $A remains stubbornly high at just over parity with the US dollar. This is another issue which caused much excited debate and some confusion in 2012. Many market participants, who were relying on old models of the currency driven by commodities and interest rates, missed the point that the $A is now more closely correlated with the global equity markets and goes up or down as investors’ preference for risk comes and goes.

Looking Ahead

The coming year will continue to see investors fret about the issues which preoccupied them in 2012. In particular, what the pace of growth in the major economies will be and how Europe handles further systemic problems that are bound to arise. In Australia, debate will focus on how far the economy slows down, how much further the Reserve Bank cuts interest rates and what happens to the Australian dollar. On top of this, politics will remain disruptive. Australia, Italy and Germany all have elections in 2013 (Australia by end-November, Italy in April and Germany in September/October) and the Catalonian secessionist movement will continue to pursue its agenda in Spain. In short, there will be plenty of opportunities for investors to worry that things are not going as well as they should. However, while we acknowledge the potential for elections and unforeseen events to create uncertainty and temporary bouts of risk aversion, we are inclined to a more optimistic view of how 2013 may unfold.

In the US there are some promising signs for economic growth. The leading indicators of construction activity in the housing market suggest the number of new house starts could increase by as much as 50% in 2013. Although the housing market is now a smaller part of the US economy than it was before the GFC, this pace of activity would still make a meaningful contribution to the overall growth of the economy. In addition, there would be second-round effects as consumer durable items are acquired to fit out the new homes.

The US unemployment rate has finally fallen below 8% and there are signs it will continue to decline gradually in coming months. This is of course important for consumer confidence and spending. The latest indicators of manufacturing activity also look better than they have for several months. Most importantly, inflation and expectations of inflation remain under control. This provides the Federal Reserve with the room it needs to continue providing support to the economy.

The big risk to the US economy is of course the fiscal cliff which became the focus of attention after the Presidential election. Once again politicians have demonstrated a remarkable ability to leave necessary solutions to the very last minute. The latest reports suggest that the worst of the cliff will be avoided, but these issues will be revisited in February when the debt ceiling limit is due for another extension.

Despite all the angst the Europeans have caused over the past couple of years, they have actually been making significant progress in restructuring their economies. This will continue in 2013 with further steps to manage national debt and improve the competitiveness of the member states. There are signs of this happening already and although Europe will experience weak growth in 2013 and more very high unemployment in countries like Spain Greece and Italy, they are already starting to see some benefits from their austerity programs.

In doing all this, the Europeans are laying the foundations for significant economic success a few years down the track. The US has always been a relatively flexible and adaptable nation and the shale gas revolution going on over there will provide a major boost to their economy. They too have the opportunity to lay some important economic foundations in coming years. In contrast, Australia seems stuck in a rut. Our economy has become less flexible and less productive while the size of government has increased. The need for restructuring the mix of economic activity away from the mining sector is apparent to everyone but there is no consensus on how this is to be done. The political situation in Canberra has created considerable uncertainty, which has caused many businesses to put off making decisions until after the next Federal election. If, as seems likely, the election is held later rather than sooner in 2013, then the year could see little progress made on necessary economic reform.

We are more optimistic about China and Japan. The change in economic policy in Japan following the recent election will benefit not just the Japanese economy but also other nations in the region. Although we do not expect to see China return to growth rates of 10% or more, nevertheless the leading indicators suggest that China will grow by at least 8% in the coming year with a chance of reaching 9%. Looking further ahead, a more sustainable pace of growth for China as they restructure their economy is probably closer to the 7% to 8% range.

What does all this mean for financial markets and potential opportunities for investors? We think the following points are important to bear in mind:

- interest rates around the world will remain low not just in 2013 but probably for another couple of years after that;
- the Reserve Bank is likely to cut interest rates again in 2013; the precise amount of any cuts will

depend on how conditions unfold, but it is not hard to see another 0.5% of cuts in the coming year;

- as economic activity around the world improves in 2013 and shocks to the global financial system (such as national debt and banking crises) diminish, so the demand for government bonds as a safe haven investment will also diminish;
- we do not expect to see a big sell-off in government bonds in 2013, but rather a gradual increase in yields; government bonds will be most at risk when global interest rates start to increase in a couple of years' time;
- the demand for yield is likely to continue at least in the first half of 2013 until investors become more confident about opportunities for capital gains in more cyclically-oriented equities;
- this means that already expensive high yield assets are likely to become even more overvalued before they eventually sell off;
- equity markets should continue to improve in 2013 as investors re-evaluate the prospects for global growth and unwind some of the pessimism left over from 2012;
- global equities are likely to perform better than Australian equities given our expectations about their relative pace of growth and reform; Australian equities can still rally in the wake of improving global markets;
- valuation also still favours the Australian equity market both in absolute terms and relative to bonds;
- Australian small cap stocks are likely to continue to underperform large cap stocks until the economy shows clear signs of improvement which may not happen until 2014;
- the Australian dollar is likely to remain above parity with the US dollar for some time yet; one of the key reasons why the Australian dollar is strong is because the US has been running a deliberate policy of making their currency weak; until the US reverses this policy, which will not happen until the Federal Reserve decides it is time to lift interest rates, the Australian dollar will remain high; we expect this situation could persist until 2014/15;
- In the meantime, if China and Japan experience the kind of growth we are expecting in 2013 then it is likely that the Australian dollar will rise further against the US dollar into the 1.05 to 1.10 range.

If our outlook is correct, then investors should consider using 2013 as an opportunity to re-weight their portfolios towards equities, first away from cash and government bonds and then away from higher yield defensive assets. Our equity market handsomely beat government bonds and credit over the past six months and we see scope for this to continue in 2013. Within equities, investors should favour the international markets over Australia in 2013, particularly the Asian equity markets. Investors should also continue to hedge international assets and enjoy a positive, albeit shrinking, interest rate premium while avoiding the cost of an appreciating exchange rate.

DFS Model Portfolios – Performance Commentary – December 2012 Quarter

Overview – December 2012 Quarter

The December quarter saw significant political elections held in the United States of America, China, and Japan. Barrack Obama was re-elected as President of the USA, Xi Jinping replaced Hu Jintao as General Secretary of China's ruling Communist Party and Shinzo Abe, who resigned as Prime Minister in 2007, is once again Japan's Prime Minister. With the elections completed, capital markets then focussed their attention on whether the US Congress was closer to finding a resolution to the looming budgetary concerns brought about by the expiration of the Bush-era tax cuts and automatic reduction in government spending. Termed the "fiscal cliff", these budgetary constraints threatened to tip the US into recession which would no doubt have a flow on effect to the global economy. Australian investors were obviously optimistic that the issues would be resolved as the Australian equity market continued to rally; the ASX300 Accumulation Index adding another 6.77% for the quarter to finish off 2012 an impressive 19.74% better off than a year ago.

Reflecting over the last 12 months, we are extremely pleased with the overall performance of our Model Portfolios. Our strong focus on downside risk management meant that whilst we were not immune to the ongoing macro-driven volatility that plagued global financial markets throughout 2012, all of our Model Portfolios produced positive absolute returns for the year. Importantly, the longer term performance of our Models is just as impressive.

Australian Equities Large Caps (AEQ)

Three consecutive months of positive returns saw the Australian share market rise by 6.76% during the December quarter. Over the year, the market produced 11 months of positive returns with May's 6.74% decline the only hiccup in what has been a rewarding year for equity investors. Leading the way was the Telecommunications sector, generating a return of 11.36% for the quarter whilst Energy stocks declined 0.26% to be the markets sole detractor for the period.

In economic news, September quarter GDP figures were released which showed the Australian economy growing by 0.5% over the quarter and 3.1% year on year (seasonally adjusted) whilst the Terms of Trade (which measure the price of exports relative to imports) fell by 4% and 13.7% over the same periods. The Consumer Price Index rose 0.2% in the December quarter and 2.2% for the year. The most significant price rise was for domestic travel whilst vegetable prices decreased. The Reserve Bank of Australia reduced the cash rate by 50 basis points over the quarter to see the official cash rate return to its GFC low of 3%. Australia's unemployment rate increased 0.1% to 5.4% (seasonally adjusted) and the Australian Dollar closed at $1.0384 USD.

Returns: The DFS Large Cap Model generated a return of 6.99% for the December quarter, outperforming the Index by 0.23%. Over the year the AEQ Model underperformed the market benchmark by 1.00%, generating a return of 18.74% compared to Index which returned 19.74%.

Positive performers within the DFS AEQ Model included positions in Boart Longyear, Mount Gibson Iron and Fortescue Metals Group which all benefited from an appreciating iron ore price. Short positions across the building materials and mining services sectors and a short position in Worley Parsons also contributed. Detractors on performance included Regis Resources and PanAust.

The DFS AEQ Model is constructed with the objective of outperforming the market benchmark during a period of anticipated volatility and will remain significantly skewed towards high quality businesses which are less dependent on easy credit and buoyant economic conditions to support profits.

Australian Equities Small Caps

Returns: The DFS Small Cap Model generated a return of 4.94% for the December quarter, outperforming the S&P/ASX Small Ordinaries Accumulation Index by 2.90%. Over the year, the DFS Small Cap Model has generated a return of 14.68% compared to the market benchmark which has returned 6.58%. This translates to an impressive 8.11% outperformance for the year.

Major contributors at the underlying stock level included were M2 Telecommunications, Super Retail Group and Ramsay Healthcare while the major detractors to performance included positions in Regis Resources, Saracen Minerals and an underweight position in Perpetual.

Our review of Australian small cap managers reaffirmed our preference to allocate to active managers with true small cap exposure to better capture the inefficiencies that exist in this market segment to generate outperformance over the long term.

International Equities Large Caps (IEQ)

Global equity markets also produced positive returns over the December quarter with the MSCI World ex-Australia Index returning 2.49% in Australian Dollar terms and 2.78% in local currency terms. Overall, global equity markets continued to appreciate following the promise of significant and sustained liquidity injections from the US Fed and European Central Bank (ECB).

Regionally performance was mixed over the quarter; the S&P 500 Index declined -1.01%, the FTSE 100 was up 2.71%, Germany's DAX appreciated 5.49% with Japan's Nikkei the clear standout, , closing 17.19% higher.

Returns: **The DFS IEQ Model generated a return of 4.68% for the quarter, outperforming the market benchmark by 2.19%. The IEQ Model outperformed the market benchmark by 2.03% over the year, generating a return of 16.18% compared to the Index which returned 14.14%.**

The IEQ 6 monthly intra-cycle review was conducted in September which resulted in a restructure of the Model. The restructure also resulted in DFS increasing the level of AUD hedging to 25% in September. Notwithstanding the recent decrease in interest rates by the Reserve Bank of Australia (RBA) which has seen official borrowing costs reduced to 3.00%, interest rate differentials between Australia and most developed economies remain elevated at an average level of around 2.50% p.a. This is the incremental return that investors earn on the *fully hedged* component of their international equities. We have further confidence (perhaps against consensus) that the AUD will hold up during risk-off periods as observed leading up to Greece's June elections. DFS continues to monitor the hedging position closely and will reassess the hedging level further as the bias on interest rate differentials begins to ease.

Positions in eBay, Visa Inc, Vale, Cannon, Grendene and BMW were positive contributors whilst Vodafone Group, Petrobas, and PepsiCo detracted. The Model also benefited from the overweight exposure to emerging markets. From a sector perspective, positions in HealthCare, Consumer Discretionary and Financial stocks contributed to the Model's performance.

International Equities Asia Ex-Japan

Asian equity markets put in another solid performance in the December quarter with the MSCI AC Asia ex-Japan Index appreciating 5.87% for the period. Regionally, Hong Kong's Hang Seng Index returned 8.72% and India lagged the rest of the region, the country's SENSEX Index returning 3.53% over the period.

Returns: **Over the December quarter, the DFS Asia Ex-Japan Model generated a return of 7.19% outperforming the Index by 1.32%. The Model also outperformed the Index over the course of the year, generating a return of 21.23% compared to the market benchmark which returned 20.83%. The DFS Asia Ex-Japan Model was also restructured in September following the completion of our intra-cycle review on the sector. DFS believes that the Model is in a strong position to capitalise on a segment of the Asian market (approx. $1 billion capitalisation) that previous managers had difficulty accessing due to size.**

Positive contributors to the Model's performance included Wumart Stores, Siam Cement, Ctrip.com Ltd and HiteJinro whilst detracting on performance were Unilever Indonesia, Turquoise Hill Resources and Jobstreet Corporation.

Global Infrastructure (GI)

Returns: **Over the December quarter the DFS Global Infrastructure Model returned 4.17% slightly underperforming the Index which generated a return of 4.36%.** Over the year the GI Model has generated a return of 18.76% compared to the market benchmark return of 16.91%

Positive contributors to the Model's performance were infrastructure conglomerate Abertis Infraestructuras, and toll road holdings SIAS, TOMI, Atlantia and Shenzhen International. Detracting on performance were the Model's holdings in various Japanese gas utilities following the election of a pro-nuclear government.

Global REITs (GREITS)

<u>Returns:</u> **The DFS Global REITs Model returned 6.79% for the December quarter, outperforming the market benchmark by 1.38% which generated a return of 5.41%.** Over the year the GREITs Model generated a return of 31.19%, outperforming the Index by an impressive 4.50%.

Positive contributors to the Model's performance were overweight positions in Austrian retail stock Atrium, UK storage REIT Big Yellow Group and Singapore listed industrial property stock Global Logistic Properties. US REITS were the main sources of underperformance during the quarter, in particular SL Green, AvalonBay Communities, Home Properties and Equity Lifestyle Properties.

Australian REITs (AREITs)

Australian listed property trusts continued its charge, closing another 6.95% stronger in December. Overall, the AREIT market generated a return of 32.79% over the course of 2012..

<u>Returns</u>: **The DFS Australian REIT Model outperformed the market benchmark during the quarter, returning 7.11% for the three month period. The Model also outperformed the Index for the year, returning 33.26%.**

Major factors contributing to the Model's quarterly performance were overweight positions in Charter Hall Retail REIT, and Goodman Group whilst an underweight position in Australand Property Group was the major detractor for the quarter.

Alternative Investment Strategies (AIS)

DFSMA clients only

DFS launched an expanded AIS Model to include Gold Bullion, Diversified Hedge Funds, Commodities, Managed Futures and Global Macro Strategies. The objective of our Alternative Investment Strategy (AIS) Portfolio is to generate positive (absolute) returns in both rising and falling equity market conditions, enhancing the diversification dynamics within client portfolios.

<u>Returns:</u> **The DFS Alternative Investment Strategies Model returned -0.87% for the December quarter, compared to cash which generated 0.81% and the HFRI Macro Total Return Index which generated 1.04%. Notwithstanding the short term negative performance, the AIS Model returned 1.63% for the 2012 calendar year.**

We highlight that the performance of Alternative Investment Strategies in general have struggled over the last 2 years. Whilst the DFS AIS Model returns were positive over the last 1 & 2 years, they were limited to 1.63% and 1.32%p.a., respectively. This compared favourably to respective returns of -0.18% and -4.33%p.a. generated by the HFRI Macro Index. It appears that the whipsawing (risk on/off) market environment of 2011 got the better of AIS managers. Moreover, the fall in broad equity risk throughout 2012 did not auger well for AIS managers as there were few opportunities to exploit across the various sectors that make up the aggregate market. Thus 2012 rewarded pure equity market exposure (beta managers) rather than AIS managers that seek to generate non equity market returns.

Gold Bullion continued its whipsawing behaviour; the precious metal depreciating 6.34% in Australian Dollar terms for the quarter. **Global Macro Strategies'** were higher with overall asset allocation and a net short position in commodities the main contributors. Our **Managed Futures Strategies** detracted primarily due to a net short position in agriculture and a net long position in metals. The newly-appointed **Currency** strategy also detracted on performance; a long position in the Japanese Yen and short position in New Zealand Dollar were particularly detrimental. The strategy maintains a net short position in the Australian Dollar. Our **Diversified Hedge Funds** strategy was flat with December's positive return offsetting small losses in October and November. Our **Absolute Return Fixed Income** strategy continued to perform strongly with overweight positions in floating rate credit and higher yielding securities benefiting from narrowing credit margins.

Sovereign Bonds

Bond markets rallied for much of the December quarter, with December the only hurdle as markets decided to track the headlines surrounding the US fiscal cliff. European bond markets had a relatively strong quarter with both German and Italian rates rallying. Domestically, the RBA reduced the cash rate to 3.00% which augered well for the short end of the yield curve however Australian Government Bond yields rose about 30 basis points overall. Credit markets continued with another quarter of strong performance, the average spread over Government bonds for the Barclays Global Corporate Index contracting a further 29 basis points to 1.40%. Emerging market bonds also continued to outperform. European credit spreads continued to be supported by the prospect of the ECB Outright Monetary Transactions, as did Asian credit spreads as investors become more confident in the increasingly self-sustaining Asian economies. This sentiment was also witnessed domestically; the Australian iTraxx Index finished 34 points tighter at 124.

<u>Returns:</u> **The DFS Sovereign Bond Model generated a return of 0.50% for the quarter, outperforming the Australian based UBS Composite Bond benchmark by 0.29%.** Over the twelve

month period, the Sovereign Bonds Model returned 7.82% marginally outperforming the Index which generated a return of 7.70%. The Sovereign Bond Model is currently weighted 55%/35% in favour of domestic bonds with the remaining 10% allocated to inflation-linked securities.

Diversified Credit and Fixed Income

Returns: Over the December quarter, the Diversified Credit and Fixed Income Model returned 2.51% compared to the Barclay's Capital Global Corporate Credit Total Return Index which returned 2.92%. For the year the Model generated a return of 13.00%, underperforming the Index which returned 16.11%

Positive contributors to the Diversified Credit & Fixed Income Model's performance included tactical allocations to financials and non-Agency mortgage-backed securities whilst an exposure to government-related securities detracted as corporate securities outperformed. The top performing leveraged loan industries were once again utilities and media/telecom whilst the worst performing loan industry was the aerospace industry. At the end of December the Model's yield to maturity was 7.19% p.a. with interest rate duration of 3.02 years and credit spread duration of 3.06 years.

Enhanced Cash

Returns: ***The DFS Enhanced Cash Model*** returned 1.63% for the December quarter, outperforming the Australian 90-Day Bank Bill Index by 0.82%. The Model has now generated a return of 7.29% for the year, outperforming its Index by 3.54%. Overall macro strategies added value over the quarter with the country spreads; in particular Australia vs. US and Canada vs. US positions whilst a long Australian duration position also contributed modestly. At the end of December the Model's interest rate duration was 0.79 years with a running yield of 4.42%.

Overlays to the IEQ Model

We note that the overlays were limited to a small part of our clients' portfolios due to our ongoing focus on risk management. With the benefit of hindsight, we acknowledge that all and any leveraged investments (even those with a high risk management imperative such as the HFA/Lighthouse stable of funds) should have been avoided as the forced selling of the financial crisis has severely amplified losses across all capital markets.

HFA Octane Asia – Geared investors only remaining. The fund returned 1.45% over the December quarter compared to 5.73% for the market benchmark. The fund's since-inception return is -0.03% p.a. versus 1.75%p.a. for the benchmark. Clients with **geared** HFA Octane Asia holdings have remained invested due to the excessive cost of exiting. ***An equity option overlay has been implemented for those clients that requested re-exposure to Asian and/or Australian equity markets.***

Direct Property Syndicate Overlay

Returns: The Charter Hall Direct Property Fund (CHDPF) and Colonial First State Private Investor Fund (PIF1) generated returns of 0.42% and 1.36% respectively over the December quarter. The majority of markets are seeing vacancy levels higher than the 10 year average, with Perth (5.6%) the only major CBD showing a vacancy rate below 8%.Rental growth across the major capital cities increased 1.7% for the year.

Colonial - PIF

PIF1 underperformed the market benchmark during the December quarter and announced a quarterly distribution of 0.246 cents per unit. As part of the fund's divestment program, a number of assets were sold during the quarter with proceeds to be distributed to investors by way of a special distribution. Proceeds are expected to be received in February.

	3 Months	6 Months	1 Year	2 Years	3 Years	4 Years	5 Years
CFS Private Investor Fund	1.36%	1.94%	0.69%	1.74%	1.73%	-6.05%	-6.98%
Mstar Unlisted & Direct Property Index	2.09%	3.82%	8.27%	3.49%	3.22%	-1.84%	-3.51%
Out(Under)performance	*-0.73%*	*-1.88%*	*-7.58%*	*-1.75%*	*-1.49%*	*-4.21%*	*-3.47%*

Charter Hall – CHDPF

Over the quarter, CHDPF's asset management team finalised leasing or signed Heads of Agreement (HOA) on 3% of the portfolio. Portfolio occupancy is 95% with a weighted average lease expiry of 4.2 years. The fund's gearing level increased to 47% following the acquisition of 181 St Georges Terrace, Perth for $26.8 million. The transaction positively impacted the Fund's yield which is expected to increase to approximately 8% from the March 2013 quarter onwards.

	3 Months	6 Months	1 Year	2 Years	3 Years	4 Years	5 Years
Charter Hall Direct Property Fund	1.43%	2.85%	9.11%	11.54%	10.47%	-2.05%	-5.95%
Mstar Unlisted & Direct Property Index	2.09%	3.82%	8.27%	3.49%	3.22%	-1.84%	-3.51%
Out(Under)performance	*-0.66%*	*-0.97%*	*0.84%*	*8.05%*	*7.25%*	*-0.21%*	*-2.44%*

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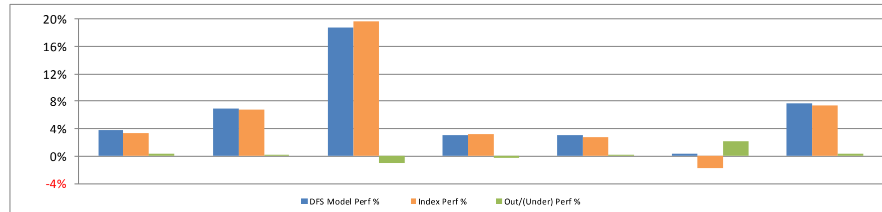
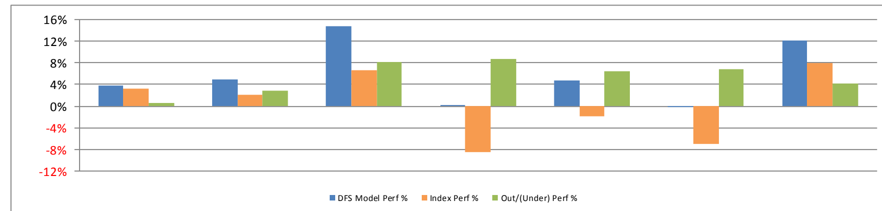
DFSPS employs an evidenced based approach to its manager selection process and believes that high barriers to successful entry exist that preclude more than 85% of active managers from generating sustainable risk-adjusted returns. DFSPS further believes that high quality active will generate meaningful levels of alpha (particularly during volatile market periods) and places a high degree of emphasise on downside risk management. Forward looking considerations are integral to the manager selection as part of the portfolio construction process.

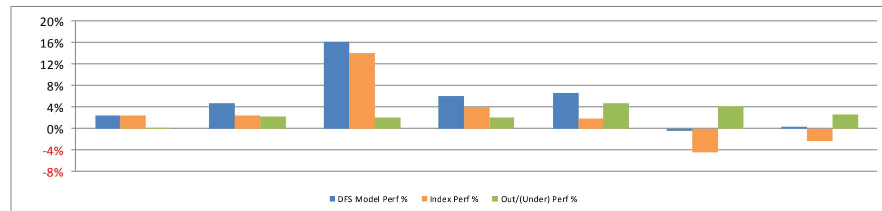
GROWTH PORTFOLIOS	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception Jan '00 (p.a.)
AUSTRALIAN EQUITIES LARGE CAP PORTFOLIO	**3.76%**	**6.99%**	**18.74%**	**3.06%**	**3.01%**	**0.37%**	**7.69%**
INDEX -S&P/ASX 300 Accumulation Index	*3.33%*	*6.77%*	*19.74%*	*3.25%*	*2.80%*	*(1.81%)*	*7.36%*
Outperformance/ (Underperformance)	***0.42%***	***0.23%***	***(1.00%)***	***(0.18%)***	***0.21%***	***2.17%***	***0.33%***



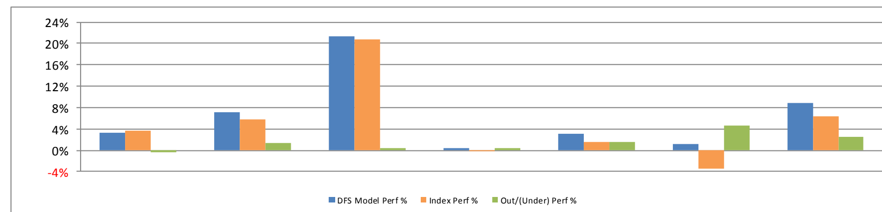
	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception Nov '02 (p.a.)
AUSTRALIAN SMALL CAP EQUITIES PORTFOLIO	**3.84%**	**4.94%**	**14.68%**	**0.23%**	**4.67%**	**(0.20%)**	**12.21%**
INDEX - S&P/ASX Small Ordinaries Accum Index	*3.23%*	*2.04%*	*6.58%*	*(8.49%)*	*(1.81%)*	*(6.94%)*	*8.00%*
Outperformance/ (Underperformance)	***0.60%***	***2.90%***	***8.11%***	***8.73%***	***6.48%***	***6.74%***	***4.21%***



	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception Jan '00 (p.a.)
INTERNATIONAL EQUITIES PORTFOLIO	**2.51%**	**4.68%**	**16.18%**	**6.05%**	**6.67%**	**(0.49%)**	**0.25%**
INDEX - MSCI World Ex Aus Acc. Index (AUD)	*2.34%*	*2.49%*	*14.14%*	*3.95%*	*1.91%*	*(4.55%)*	*(2.37%)*
Outperformance/ (Underperformance)	***0.17%***	***2.19%***	***2.03%***	***2.10%***	***4.76%***	***4.05%***	***2.62%***



	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception July '05 (p.a.)
INTERNATIONAL EQUITIES PORTFOLIO - ASIA	**3.21%**	**7.19%**	**21.23%**	**0.40%**	**3.15%**	**1.07%**	**8.88%**
INDEX - MSCI AC Asia Ex Japan NR AUD	**3.63%**	**5.87%**	**20.83%**	**(0.05%)**	**1.59%**	**(3.45%)**	**6.27%**
Outperformance/ (Underperformance)	***(0.42%)***	***1.32%***	***0.40%***	***0.45%***	***1.56%***	***4.53%***	***2.60%***



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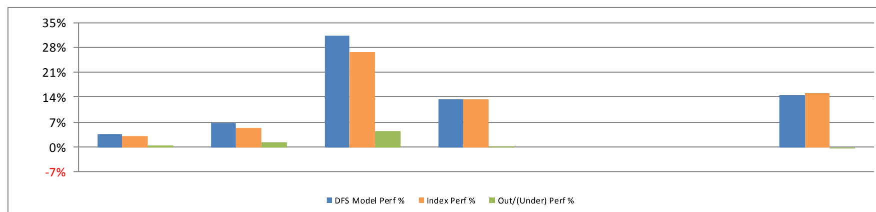
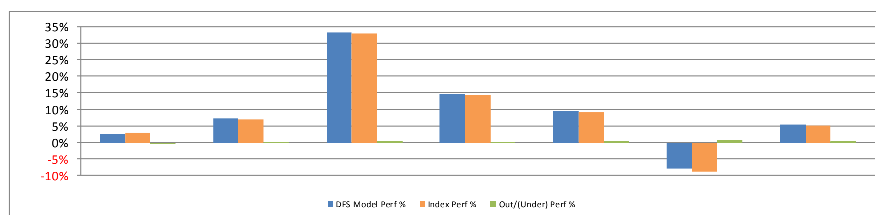
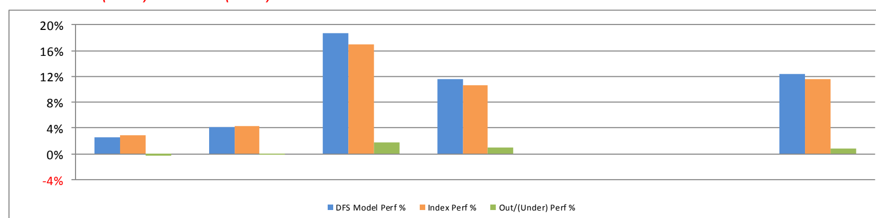
GROWTH PORTFOLIOS continued	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception Oct '10 (p.a.)
GLOBAL REITS PORTFOLIO	**3.61%**	**6.79%**	**31.19%**	**13.46%**	NA	NA	**14.61%**
INDEX - UBS Global Investors GREITs Index (Hedged AUD)	*3.02%*	*5.41%*	*26.69%*	*13.36%*	NA	NA	*15.10%*
Outperformance/ (Underperformance)	*0.59%*	*1.38%*	*4.50%*	*0.10%*	NA	NA	*(0.49%)*



	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception Jan '00 (p.a.)
AUSTRALIAN REITS PORTFOLIO	**2.57%**	**7.11%**	**33.26%**	**14.54%**	**9.49%**	**(7.92%)**	**5.50%**
INDEX-S&P/ASX 300 Property Accumulation Index	**2.86%**	**6.95%**	**32.79%**	**14.33%**	**9.09%**	**(8.66%)**	**5.05%**
Outperformance/ (Underperformance)	*(0.29%)*	*0.15%*	*0.46%*	*0.21%*	*0.40%*	*0.74%*	*0.45%*



	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception Oct '10 (p.a.)
GLOBAL INFRASTRUCTURE PORTFOLIO	**2.56%**	**4.16%**	**18.76%**	**11.61%**	NA	NA	**12.40%**
INDEX - UBS Global Infrastructure & Utilities 50/50 TR Index AUD	**2.87%**	**4.26%**	**16.91%**	**10.61%**	NA	NA	**11.54%**
Outperformance/ (Underperformance)	*(0.31%)*	*(0.09%)*	*1.85%*	*0.99%*	NA	NA	*0.87%*



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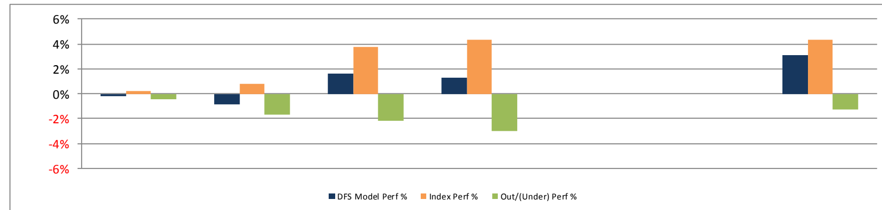
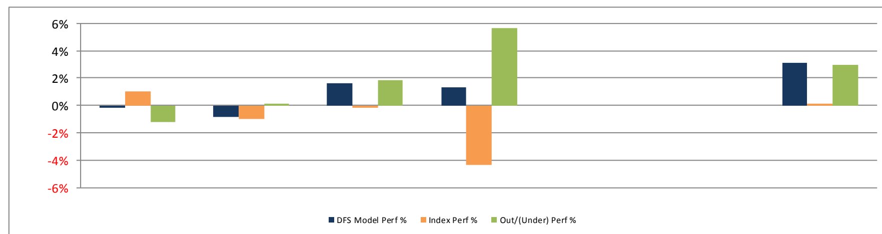
dfs portfolio solutions

The objective of the AIS Model is to provide diversifying return drivers against traditional asset classes and to generate positive (absolute) returns during rising and falling equity market conditions over the medium term. The AIS Model has been designed with specific considerations that were highlighted during the Global Financial Crisis. Consequently, liquidity (daily NAV), leverage and transparency are focal points. The AIS Model dynamically allocates to (1) Gold bullion; (2) Commodities; (3) Diversified hedge funds; (4) Managed Futures (5) Global Macro; & (6) Cash.

ALTERNATIVE INVESTMENTS PORTFOLIOS	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception Oct '10 (p.a.)
ALTERNATIVE INVESTMENT STRATEGIES PORTFOLIO	(0.20%)	(0.87%)	1.63%	1.32%	NA	NA	3.08%
INDEX - 90 Day Australian Bank Bill Index	*0.26%*	*0.81%*	*3.76%*	*4.30%*	NA	NA	*4.38%*
Outperformance/ (Underperformance)	*(0.46%)*	*(1.67%)*	*(2.12%)*	*(2.98%)*	NA	NA	*(1.30%)*



ALTERNATIVE INVESTMENTS PORTFOLIOS	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception Oct '10 (p.a.)
ALTERNATIVE INVESTMENT STRATEGIES PORTFOLIO	(0.20%)	(0.87%)	1.63%	1.32%	NA	NA	3.08%
INDEX - HFRI Macro Total Return Index	1.04%	(1.02%)	(0.18%)	(4.33%)	NA	NA	0.14%
Outperformance/ (Underperformance)	*(1.24%)*	*0.15%*	*1.81%*	*5.65%*	NA	NA	*2.94%*



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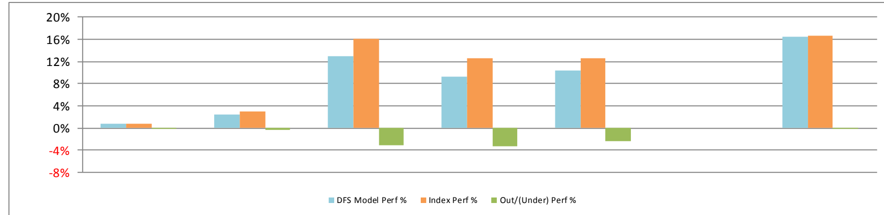
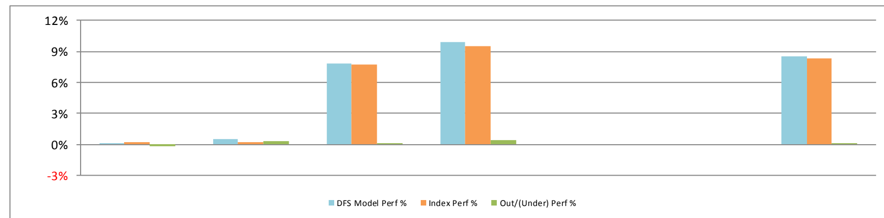
DFSPS employs an evidenced based approach to its manager selection process and believes that high barriers to successful entry exist that preclude the vast majority of active managers from generating sustainable risk-adjusted returns. In the event that active management fails to consistently produce risk-adjusted returns in excess of the market benchmark, DFSPS will adopt a passive approach to obtain exposures in those sectors. DFSPS research continues to indicate that a high degree of efficiency exists within sovereign debt markets and that active management should be limited to high-yield & credit market exposures.

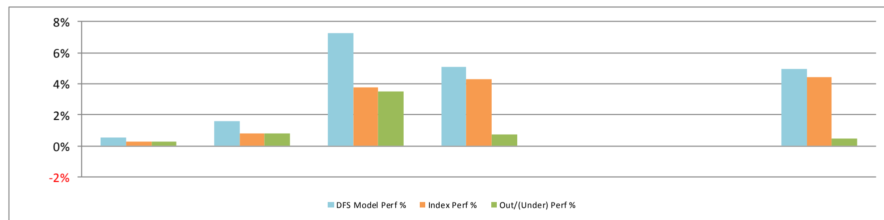
DEFENSIVE PORTFOLIOS	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception April '09 (p.a.)
DIVERSIFIED CREDIT & FIXED INCOME PORTFOLIO	**0.70%**	**2.51%**	**13.00%**	**9.23%**	**10.32%**	**N/A**	**16.50%**
INDEX - BarCap Global Corporate Credit Total Return (AUD)	**0.79%**	**2.92%**	**16.11%**	**12.52%**	**12.63%**	*N/A*	*16.56%*
Outperformance/ (Underperformance)	*(0.08%)*	*(0.41%)*	*(3.10%)*	*(3.29%)*	*(2.31%)*	N/A	*(0.06%)*



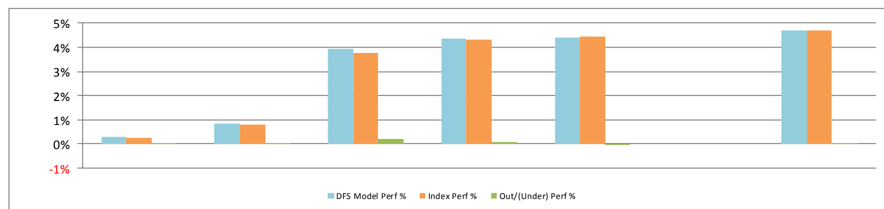
	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception Jan '10 (p.a.)
SOVEREIGN BONDS PORTFOLIO	**0.05%**	**0.50%**	**7.82%**	**9.94%**	**N/A**	**N/A**	**8.48%**
INDEX-U B S Composite 0 + Years	**0.18%**	**0.21%**	**7.70%**	**9.52%**	N/A	N/A	**8.35%**
Outperformance/ (Underperformance)	*(0.14%)*	*0.29%*	*0.12%*	*0.42%*	*N/A*	*N/A*	*0.13%*



	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception May '10 (p.a.)
ENHANCED CASH PORTFOLIO	**0.54%**	**1.63%**	**7.29%**	**5.06%**	NA	NA	**4.93%**
INDEX - 90 Day Australian Bank Bill Index	**0.26%**	**0.81%**	**3.76%**	**4.30%**	NA	NA	**4.45%**
Outperformance/ (Underperformance)	*0.27%*	*0.82%*	*3.54%*	*0.76%*	NA	NA	*0.48%*



	1 Month	3 Months	1 Year	2 Years (p.a.)	3 Years (p.a.)	5 Years (p.a.)	Since Inception Feb '08 (p.a.)
CASH PORTFOLIO	**0.29%**	**0.85%**	**3.95%**	**4.37%**	**4.39%**	NA	**4.72%**
INDEX - 30 Day Australian Bank Bill Index	**0.26%**	**0.81%**	**3.76%**	**4.30%**	**4.43%**	NA	**4.69%**
Outperformance/ (Underperformance)	*0.03%*	*0.04%*	*0.19%*	*0.06%*	*(0.04%)*	NA	*0.03%*



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