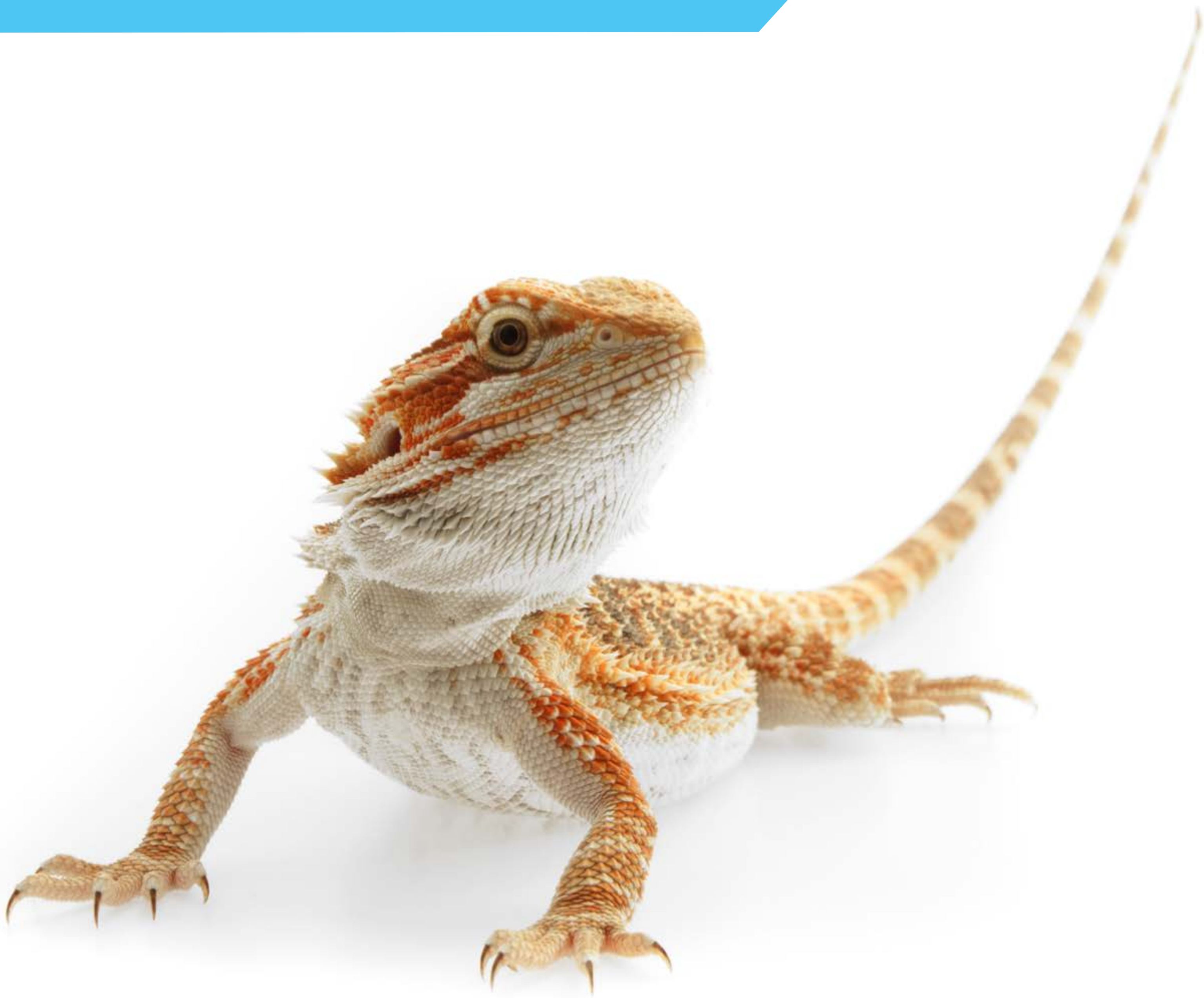
australian**ethical**
SHAREHOLDER UPDATE

Half year results to 31 December 2011



1800 021 227 • www.australianethical.com.au

australian**ethical**®
investment + superannuation

Managing Director's report

Dear Shareholder,

Australian Ethical manages the investments and super savings for over 18,000 individuals, trusts, companies and organisations. These investors have chosen our managed funds and super investments because they share our vision of contributing to a just and sustainable society and protecting the natural environment. However, our responsibility is to also deliver competitive and consistent returns to all our stakeholders, including our shareholders.

The financial services industry continues to experience the most challenging conditions it has seen for many decades and there are three main factors creating this environment.

Firstly, we are now in the fourth year of a financial downturn with markets much lower than before. As at 31 December 2011 key Australian market indicator, the S&P/ASX All Ordinaries Index, is 36 per cent lower than it was four years ago and 15 per cent lower than 12 months ago. This drop in the value of the market directly impacts our funds under management and our revenues.

Secondly, investors across the industry are now very cautious and are not investing in equities markets and managed fund products to the extent they once did. Rather, there is a large trend toward investing in 'safer' low risk, low margin products such as cash and term deposits.

Finally, there is substantial regulatory change occurring across both the funds management and superannuation industries (known as the "Future of Financial Advice" and "Stronger Super" reforms). These are being driven by the demands of an ageing population and other demographic changes as well as the Government's desire to develop a long term, sustainable and self funding super and retirement industry. The changes being implemented, together with sustained lower market values, are creating a far more competitive environment with significant downward pressure on fees.

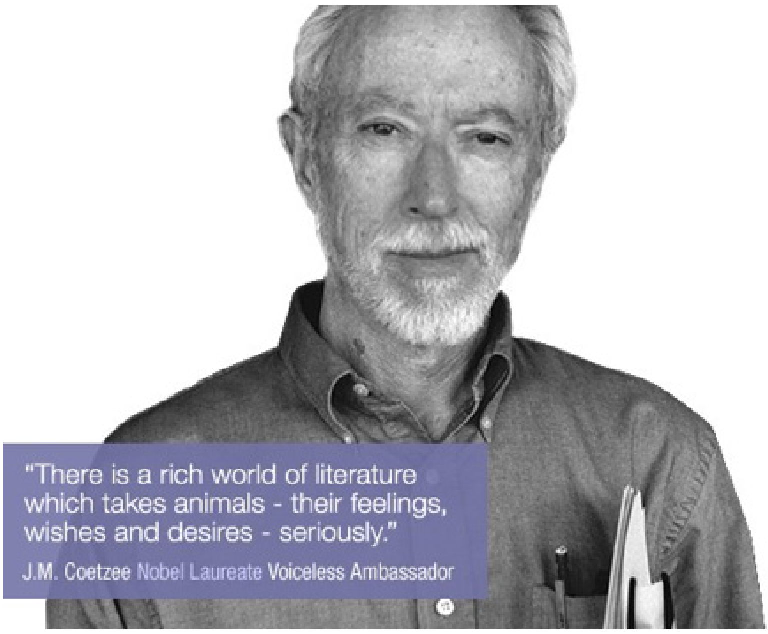
This new operating environment is a long term reality and in order to adapt to this new environment it is important that our business evolves in order to remain agile, competitive and sustainable. We need to ensure that our products are competitive in both features and price and that our service standards are at industry standard. We also need to ensure that we have the skills necessary to compete effectively in a far more competitive market and that our cost base is efficient and flexible.

We have, over the past few years, been undergoing a process aimed at improving our products, service and operating model to better position us for operating in this new environment. Our progress against these initiatives are outlined in the following pages. The changes we have made, and continue to make, will stand us in good stead as we continue to adapt and fine tune our offering to meet these challenges.

We remain firmly optimistic about the future for Australian Ethical as we are a very special company with a unique purpose. We have a clear long term strategy as to how to adapt to the new environment and we are confident that by sticking to this strategy and committing to its implementation we will continue to deliver on Australian Ethical's unique mission.

Phillip Vernon
Managing Director
29 February 2012

Voiceless is a community of informed and passionate animal advocates working together to make a difference.
Australian Ethical are proud sponsors of the 2012 Writing Prize.



The Voiceless Writing Prize sponsored by Australian Ethical Investment

Update on key business strategies

Client service

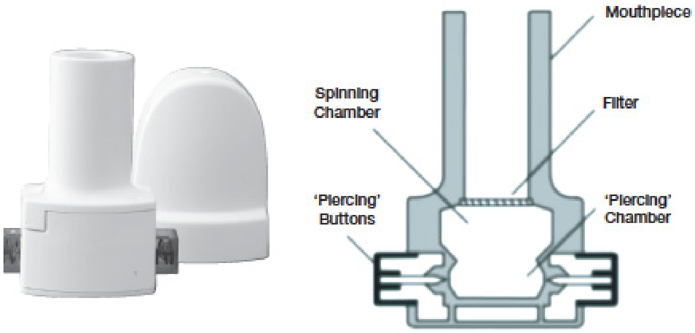
Delivering high quality client service will always be the highest priority for us. Over the period we have continued to invest in our people and systems in order to deliver on this aspect of our business. Key areas of focus have been:

- *Sales and service alignment*. The client service team now report directly through to the General Manager, Business Development ensuring a far better alignment between sales and service.
- *Improvement of service standards*. Our service standards with regard to daily unit pricing and timeliness of semi-annual distributions have vastly improved with the introduction of the Garradin portfolio management system. This 18-month project was largely completed during the period. Having service standards at this level is critical for operating in the broader adviser market.
- *Outsource provider review*. Much of our service delivery to our clients, advisers and employers is outsourced to external parties making the overall client experience less than ideal. We have commenced a comprehensive review of these arrangements to assess the best ultimate model and outcome for clients, advisers and employers. We will report further in future communications.

Advisers

Increasing our appeal and reach to the broader adviser market continues to be a key part of our strategy. Many advisers who wish to deal with us cannot access us because our funds are not readily available on dealer group platforms. Also many direct clients will often seek advice after saving with us for many years. If their adviser cannot access our products we may ultimately lose them as clients. Key initiatives to improve our offering to this market during the period were:

- *Wholesale product launch*. The launch of a wholesale unit class for our Smaller Companies Trust, Larger Companies Trust and the Climate Advocacy Fund. Having a unit of this nature is critical for advisers accessing these products on behalf of their clients.
- *Continued strong investment ratings*. Our Smaller Companies Trust and Larger Companies Trust maintained their strong ratings by reseach house Lonsec (Recommended and Investment Grade respectively). In addition, both these funds kept their rating despite the recent change in Chief Investment Officer (see below) demonstrating a growing confidence in the team by the rating agencies. The Smaller Companies Fund won **Ethical Fund of the Year** at the 2011 Sustainability Awards, recognition that it was the best amongst its peers despite the tough market.



One of our investments – Pharmaxis is a pharmaceutical business developing products for the treatment of asthma and chronic obstructive pulmonary disease (such as the bronchitol inhaler above). Recent European Union approvals have paved the way for strong regional sales growth during 2011.

- *Strengthening the sales team*. Our adviser sales and relationship management team was strengthened during the period with Adam Kirk and Steve Newnham being recruited. Both Adam and Steve have vast experience in marketing to, and developing relationships with, advisers and adviser groups (see below).

Superannuation

Super is a major growth area in financial services and developing our products and services around super remains a vital part of our strategy. Key initiatives during the period included:

- *Strengthening employer support*. Many of our clients access our super fund through employer arrangements. Providing employers with improved products and support services will make their super fund more appealing to their employees. We have increased our skills and resources focusing on supporting employers in this area.
- *Improvements to insurance options*. We concluded a review of the insurance options in our super product and will soon be upgrading them. These changes will make our super fund far more marketable.

Investment in sales and marketing

During the period we made a number of structural changes to build a more coordinated team based around sales, marketing and client service. We also welcomed a number of people who bring key sales and marketing skills to the management team critical to the new operating environment:

- Adam Kirk has a long career in corporate and retail super with Skandia, Colonial First State and Catholic Super, including working with employers and advisers in developing employee engagement in their super. Adam brings important experience and skills as we expand our services to the super market.
- Paul Smith has a background in asset consultancy and marketing within funds management as well as marketing and strategic advice to the not for profit and sustainability sectors. Paul brings a unique set of skills supporting our investment rating process as well as new ideas and approaches to strengthen our business.
- Steve Newnham has extensive experience in funds management sales and distribution with BT Australia, Zurich and Lonsec. His experience covers all aspects of sales and relationship management with dealer and adviser groups at the highest level as well as managing adviser groups. Steve had been a Non-Executive Director of Australian Ethical for 12 months prior to joining the team as an Executive Director.

Product review

We are currently undergoing a comprehensive review of all of our products to ensure that our product suite is appropriate for the competitive environment. This review has the following elements:

- *Number of products*. We are a complex business for our size and much of this complexity is driven by the sheer number of products we manage. We are reviewing each of our products for their contribution to the overall business.
- *Ensure products meet key trends*. We need to ensure that we have products to meet key market trends. One such area of focus is ensuring our products are appealing to the self managed super fund market.
- *Pricing*. With the new, more competitive environment, we need to ensure that our products are appropriately and competitively priced.
- *Features*. We need to ensure that our products have all appropriate features to satisfy client needs. Our impending introduction of improved insurance options for our super product is an example of this.

An example from our new advertising campaign commenced in 2011.

Changes to investment team

As previously announced (ASX release 13 February 2012) James Jordan, our Chief Investment Officer, recently resigned to resume his career in the Australian Public Service. We were pleased to appoint David Macri as his replacement. David has been with Australian Ethical for over three years and was a portfolio manager and analyst with the domestic equities team. Prior to joining Australian Ethical his career covered equities analysis, strategic asset allocation and asset consulting with the likes of Macquarie Group, Credit Suisse and Mercer.

Staff survey

During the period we conducted what will be an annual staff survey. The results were excellent and were highlighted at last year's Annual General Meeting and detailed in our 2011 Sustainability Report.

Financial results to 31 December 2011

	Half year 2011	Half year 2010*	Change
Funds under management	$599m	$654m	(8%)
	$000	**$000**	
Total revenue	6,834	7,127	(4%)
Total expenses	(5,939)	(5,999)	1%
Operating profit	**895**	**1,128**	**(21%)**
Community grants	(37)	(56)	33%
EBITDA	**858**	**1,072**	**(20%)**
Depreciation/amortisation/ rights/options	(347)	(390)	11%
Tax	(227)	(267)	15%
Net profit after tax	**284**	**414**	**(31%)**
Underlying profit			
Adjustments (gross)			
- Add back employment restructure expenses	110	–	
Tax on adjustments	(33)	–	
Net underlying profit after tax	**361**	**414**	**(13%)**
Dividends paid	**$0.25**	**$0.45**	
Earnings per share	**$0.28**	**$0.42**	

** An adjustment has been made to the prior period result (see below)*

Operating environment

As described earlier the operating environment for financial services firms over the period was extremely challenging. There are three key drivers for this:

- Uncertainty and volatility continued to impact investment markets and has kept them subdued. The S&P/ASX All Ordinaries Index fell by 12 per cent between 30 June and 31 December 2011.
- Investor confidence has remained weak across the industry leading to significant pressure on net flows. Investors are tending to avoid investing in equities and managed funds, instead putting their investments into cash and term deposits.
- Looming regulatory changes (known as the Future of Financial Advice or FOFA and Stronger Super) are putting significant downward pressure on fees and forcing all financial services companies to re-examine their business models.

The following commentary describes the key elements of our results:

- *Funds under management (FUM)*. As at 31 December FUM had decreased by $54.4m or 8.3 per cent to $599m compared to the previous corresponding period. Over the year to 31 December 2011 we experienced net positive inflows of $12.4m however these were offset by negative market movements of $66.8m or 10 per cent versus a market fall of 12 per cent.
- *Net flows*. Over the six months to 31 December 2011, our net outflows were $3.2m. These were made up of $8.3m net inflows into our super fund, offset by net outflows from our managed fund products of $11.5m. This last figure is reflective of the trends across the industry with significant outflows experienced by most of our competitors. Responsible investment industry data (source: Plan for Life) shows that during the quarter to 30 September 2011, net industry outflows were $182m (or 4.2 per cent of total funds under management). Australian Ethical experienced net outflows of 1.9 per cent over the same period.
- *Revenues*. Our revenues were reduced by $293,000 (or 4.1 per cent) over the previous corresponding period largely due to reduced funds under management and asset based fee revenues.
- *Cash operating expenses*. Cash operating expenses have improved by 1.3 per cent over the previous corresponding period. We have achieved this whilst also realigning the business with more emphasis on client service, sales and marketing resources and reducing our costs in administration and operations.
- *Staffing.* Over the past 18 months we have reduced staff numbers from 50 to 37 (at time of writing) and restructured the operation to have a lower and far more variable cost base. This has unfortunately resulted in a number of redundancies but has also been managed where possible through tight control on the management of replacing vacant positions. The full impact of this reduction will become apparent in future periods.
- *Non-cash operating expenses***.** The amortisation of performance rights issued under the employee share scheme have decreased by $51,000. Increases due to new issuance were offset by amounts written back due to performance hurdles not being met.
- *Community grants***.** For the six months to 31 December 2011, $37,000 has been provisioned for grants bringing the total community grants since inception to over $1.3 million.

Interim dividend

The Board has declared an interim dividend of 25 cents per share. The record date will be 16 March 2012 and the payment date will be 30 March 2012. The dividend aligns with stated company dividend policy of maintaining a payout ratio of 80 per cent to 100 per cent of NPAT. The dividend reinvestment plan will not operate.

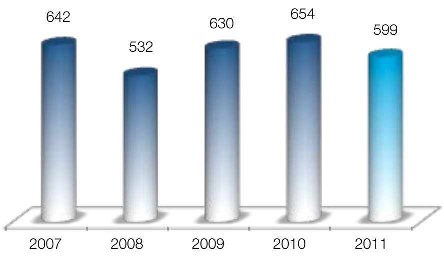
Prior year adjustment

An adjustment to the previous period has been made in respect of the amortisation of rights issued under the employee share incentive scheme. This scheme was established in 2008 to promote employee ownership in the company as well as provide flexibility in employee remuneration structures. It was approved by the shareholders in 2008 and payments have been made under the scheme since 2009.

In finalising the 31 December 2011 interim financial statements it was determined that since inception of the scheme the accounting treatment adopted for amortising the expense associated with these share based payments was incorrect. The error relates to the timing of recognising the expense, rather than the ultimate quantum. Consequently the interim result for the period to 31 December 2010 was overstated by $73,664 and an adjustment has been made to the prior result. The profit for the year ended 30 June 2011 was overstated by $157,502.

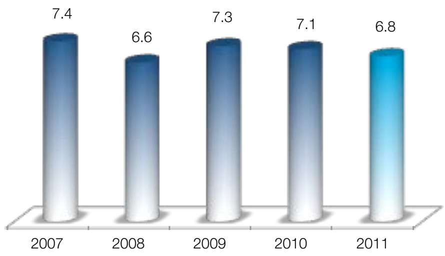
Financial summary to 31 December 2011

Funds under management ($m)



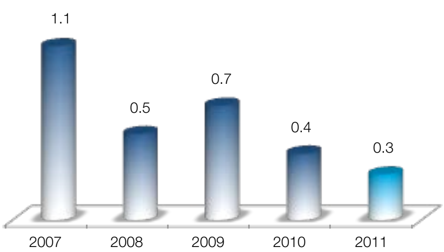
As at 31 December

Revenue ($m)



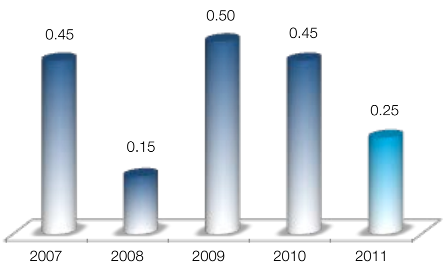
Half year ending 31 December

Net profit after tax ($m)



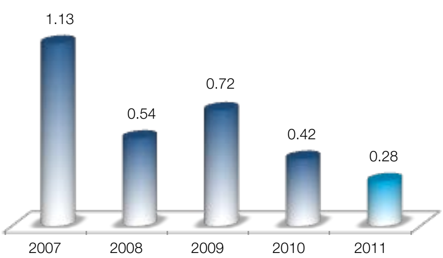
Half year ending 31 December

Interim dividend ($)



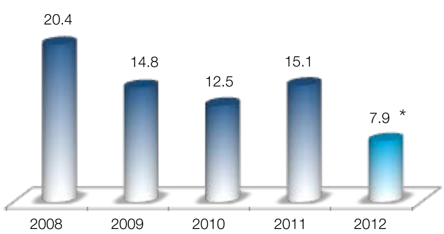
Half year ending 31 December

Basic earnings per share ($)



Half year ending 31 December

Return on equity (%)



Financial year ending 30 June

**ROE quoted for 2012 is an annualised ROE for the full year. These do not represent a forecast of full year results for the Group in respect of the 2012 financial year*