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investment + superannuation

Trusts half-year report
to 31 December 2005

Australian Ethical Trust half-year returns – a discussion with the Investment Manager

Q: Should we be happy with the half-year results to the end of December 2005, David?

A: In an absolute sense, yes. The markets were good to investors generally over the six months and our absolute return figures look quite attractive. The Large Companies Share Trust put on 12.3%; the Equities Trust 11.0%; the Balanced Trust 5.9% and the Income Trust 2.6% – just for the half-year. If we could achieve those sort of absolute returns every six months, I am sure most investors would be quite happy.

We also put some great new companies in the trusts, particularly in our international share portfolio. Some examples were hearing aid manufacturers Phonak (Swiss), William Demant (Danish), and Great Nordic (also Danish). We also added a US geothermal clean energy company, Ormat; a Dutch bicycle company, Accell, and the well-known UK company, The Body Shop. The Body Shop has since unfortunately been taken over, so we are out of that one now. We have recently approved a couple of European solar power companies, although we are waiting for better prices before we think about buying in.

Domestically, we added, among others, Victorian waste management company Baxter Group, Ceramic Fuel Cells, Brainz Instruments – a NZ company which makes brain function monitors – a wind power investment, and aged care service provider DCA Group. Even on the fixed interest side of things, after trying for some time we got hold of some Australia Post securities and we also bought some Australian dollar Sallie Mae securities at a good yield. Sallie Mae is a US company which provides the student loans which many US students rely on to go to uni.

So in addition to good absolute returns, I regard it as having been a good six months in a triple bottom line sense – the good returns have been combined with investments in companies doing good things.

David Ferris, Investment Manager

Q: Why do you keep emphasizing the word 'absolute' when talking about returns? Is there something more to the story?

A: Well, I can't hide the fact that in a relative sense the Large Companies Trust, the Equities Trust and the Balanced Trust dropped behind their benchmarks and their peers. The Equities Trust was a long way behind its benchmark and its peers for the half-year.

To put it another way – most conventional funds did better than us over the last six months. We have dropped down the league tables of fund performance that are sometimes published.

This is an extension of a medium-term trend that is apparent in the figures going back a year and beyond. Even the returns for the award-winning Balanced Trust, which on long-term performance is still one of the top funds in its category, have dropped below those of its peers recently.

The Income Trust remains ahead of its benchmark.

Q: So why have many other funds been doing better than the Australian Ethical trusts?

A: The short answer, which our unitholders are probably now very familiar with, is because we don't invest in the big coal and oil companies – the big mining stocks – and conventional funds do. Even some other funds in the so-called socially responsible investment category invest in such companies.

Australia has been having a resources boom and world energy and commodity prices are at high levels. As a result, mining stocks have been generating returns much higher than most other sectors. Over the full year to December, energy stocks returned close to 60% and Materials Sector stocks close to 40%. It is difficult to match the overall market return when the 20-25% of stocks that are earning returns like that aren't in your investment universe.

Six of the top ten contributors to overall market returns in calendar 2005 were mining stocks.

Norwegian recycler TOMRA was up a massive 82%

Q: So why don't you invest in the big coal and oil mining companies?

A: I'm surprised you have to ask! Generally, we believe that the reliance of modern society on burning coal and oil is doing tremendous damage to world ecosystems, which will impact severely on the planet and on generations to come. In short, we think extracting super-normal profits from these products is a form of stealing from the future.

In addition, the actual act of extraction is often done in environmentally damaging ways.

So we see Australian Ethical Charter items (i), (ii) and (iii) as militating against such investments.

Q: So does that mean fossil fuels and mining companies are completely ruled out?

A: No. On fossil fuels, we have taken the view that natural gas, which is so much more efficient than coal, is a useful transitional energy source until the time comes when renewable energy solutions are ready to take the major load. We therefore have a few natural gas investments, although even there we closely monitor environmental impacts and other issues.

The Australian Ethical Charter also doesn't rule out mining *per se*. While our preference is for recycling companies, like Sims Group, we recognize that modern society needs metals – trains and bicycles, for example, which we see as good things to invest in, are usually made from metal. So it would be inconsistent to completely rule out mining of metals, as an example.

To get a mining company into the portfolio we would want to see a company with exemplary environmental practices; an exemplary environmental record; a good record of working with neighbouring communities – including indigenous communities; and preferably with a mix of recycling activity in with the mining. To date, we haven't found one that we like enough to invest in.

Even with the coal and oil companies, it might be possible for a company that started a major program of shifting to renewables and pushing low-emission technologies and such like, to get considered. But most of them, even the ones sometimes advocated, still have a long way to go.

Blackmores experienced double digit share price growth during the second half of 2005

Q: Can you adjust for the mining boom to get an idea of underlying performance?

A: There are two indices we look at as an alternative to the main benchmarks for the trusts. These are the S&P/ASX Industrials index, which is essentially 'The Market' less the resources sector, and the S&P/ASX Small Industrials index, which is similar except that it also adjusts out the top 100 of the bigger stocks – many of which the Equities Trust in particular doesn't invest in. The Large Companies Share Trust returned 12.3% for the half-year in comparison with 10.7% for the Industrials index, while the Equities Trust returned 11.0% against 13.1% for the Small Industrials.

So resources boom apart, performance looks OK. The Large Companies Share Trust is actually ahead of its 'alternative' industrials benchmark for one year, two years, three years, five years and since inception.

Certainly I don't want to give the impression that only mining stocks have done well in the market! Some of our strongly ethical investments in Australian companies doing good things like Cochlear, Sonic Healthcare, clean water technology company CDS Technologies, metals recycler Sims Group, and Blackmores all had double digit share price growth during the second half of 2005. And internationally, Norwegian recycler TOMRA was up a massive 82%, while we also had good numbers from organic distributor Whole Foods, US rail company Genesee and Wyoming, and Trex Corporation, which makes decking from recycled plastic bags and other recycled materials.

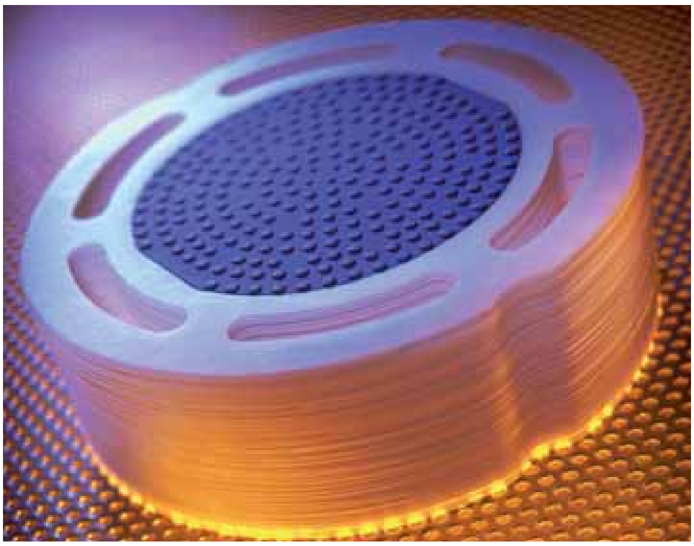
Q: Why do you use the S&P/ASX 200 and S&P/ASX 300 indices as benchmarks for the Large Companies Share Trust and the Equities Trust if your alternatives give a better indication of underlying performance?

A: A very good question which has been exercising the minds of our Board.

Benchmarks are funny things. Some funds take the market indices very seriously and use them as a major tool in constructing their portfolios. If a company made up 3% of the market index, it might be considered quite a big position for the fund to hold either 2.5% or 3.5% and they would never go outside that range. There are many conventional funds that won't stray too far away from the index in the make-up of their portfolios.

Because of who we are, with so many companies ruled out by the Australian Ethical Charter, the market index plays little or no role in our investment decision-making. The industry jargon for a fund like ours is 'benchmark unaware'.

So in some ways, it might be better if we didn't have formal benchmarks. I sometimes worry that it will make investors think that our performance is likely to be around that of the index chosen, when we are so structurally different that our performance may vary quite a bit from benchmark – sometimes better, sometimes worse. Generally better when environmental technologies, utilities and healthcare are the stronger sectors; generally worse when mining, big banks and big retailers are the stronger sectors.



New investment: Ceramic Fuel Cells. Photo: © Ceramic Fuel Cells Ltd

So I don't like the idea that saying the S&P/ASX 200 is our 'benchmark' for the Large Companies Share Trust might be taken as a promise by investors that we are going to be around the same level of return every year.

At the same time, though, investors will always be looking for something to compare performance against. If we didn't include a benchmark for comparison, people would probably just compare their returns with what their friends or neighbours got from their investments anyway. So it makes sense to put in some sort of a yardstick – otherwise you could argue that we are not being accountable for our performance.

The advantage of using a full market index (that is, they include mining stocks) like the S&P/ASX 200 (for the Large Companies Share Trust) or the S&P/ASX 300 (for the Equities Trust) as benchmark is that it gives the investor a good idea of what 'The Market' return was.

We still believe that, over the long run, we can do as well as, or even better than, 'The Market', even with mining stocks included. This arises from our belief that 'The Market' is underestimating the implications of environmental and social issues that will have impacts down the track – that there will be a big demand for clean technologies, remediation technologies, healthcare, and so on. And the performance of the Australian Ethical Trusts over the last decade does seem to bear that out.

However, it does seem that with the Australian sharemarket currently so driven by what is happening with the big banks and commodities, that our structural differences mean that any time there is a big run in these areas – either up or down – there is a good chance that our short-term and even medium-term results could diverge quite markedly from the overall market indices.

As an aside, some external commentators (and our own data supports this) suggests that historically we have tended to do better than 'The Market' during downturns and have lagged 'The Market' a bit during upturns.

However, our Board has started to think that the S&P/ASX Industrials index might be a better way for investors to get a feel for how the Large Companies Share Trust is actually performing over shorter periods; and the S&P/ASX Small Industrials index similarly for the Equities Trust. So there may be a change. We will keep unitholders posted.

The Balanced Trust's benchmark is an index based on the returns of similar funds and should be OK. Very little of this discussion impacts on the Income Trust because the mining sector issue doesn't affect it.

Q: Any further comments?

A: Our experienced investment team remains intact, and we have greatly upgraded our contact levels with investee companies over the past year.

Within the Trusts, there has been a slight increase in the proportion in international shares over the past year in the Large Companies Share Trust, the Equities Trust and the Balanced Trust. The Balanced Trust is also looking for a wider range of property investments than it has held previously. We would like to expand direct lending activity in both the Income Trust and the Balanced Trust as this is a great grass-roots way to support ethical activities, but we are not seeing a lot of demand.

Beyond that, early 2006 has started fairly well, with the share market continuing to be strong, so hopefully there will be some good full-year numbers to report on after June.

Ormat's 21 megawatt Burdette geothermal power plant at Nevada, USA

Australian Ethical Large Companies Share Trust

Performance (%)*

	1 year	3 years	5 years	since inception
Trust	18.6	21.4	10.6	13.1
ASX200 index	22.8	21.7	12.6	12.6
ASX200 Industrials	17.0	18.9	10.4	12.0

*For details on past performance see back page.

Top five holdings

Telecom Corporation of New Zealand Ltd

Insurance Australia Group

Alinta Ltd

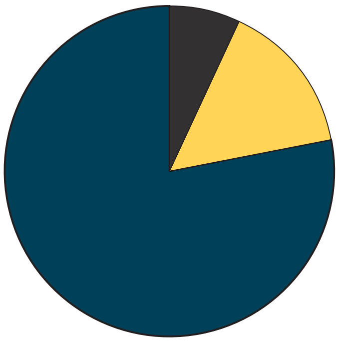
Brambles Industries Plc

Fairfax (John) Holdings Limited

Earnings

Full year	cents per unit
Distributions	1.92
Unit value change	19.70
Net earnings result	21.62

Asset allocation



Equity: Australia and NZ

Equity: International

Cash

Australian Ethical Income Trust

Performance (%)*

	1 year	3 years	5 years	since inception
Trust	5.1	5.0	4.8	4.5
CPI#+2%	4.8	4.6	4.8	4.9

*For details on past performance see back page.
consumer price index

Top five holdings

Bendigo Bank Ltd

Suncorp-Metway Bank Ltd

St George Bank Ltd

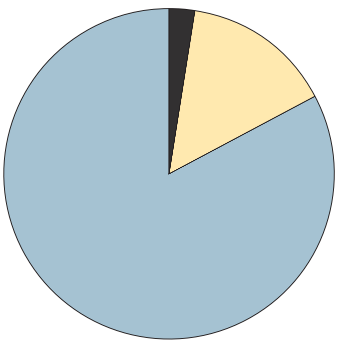
Medallion Trust

Bank of Western Australia Ltd

Earnings

Full year	cents per unit
Distributions	2.38
Unit value change	0.14
Net earnings result	2.52

Asset allocation



Interest-bearing investments

Secured private loans

Cash

Contact Australian Ethical Investment:
website **www.austethical.com.au**
phone **1300 139 447**
email **trustadmin@austethical.com.au**

Australian Ethical Equities Trust

Performance (%)*

	1 year	3 years	5 years	since inception
Trust	12.7	18.9	7.3	10.7
ASX300 index	22.5	21.7	12.7	12.2
ASX Small Industrials	15.9	24.6	11.6	10.1

Top five holdings

Timbercorp

Macquarie Communications Infrastructure Group

Insurance Australia Group

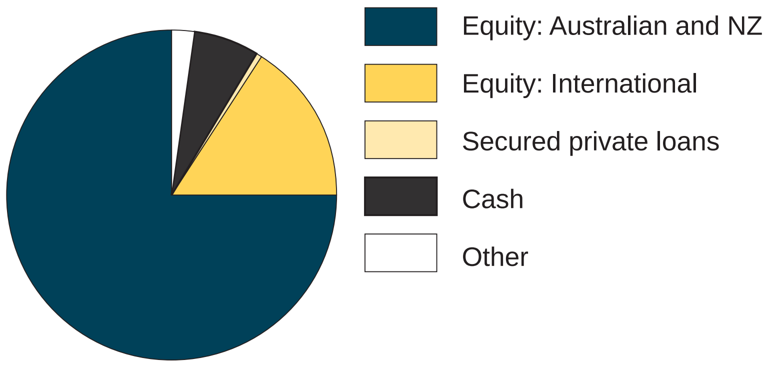
Alinta Ltd

ABC Learning Centres Ltd

Earnings

Full year	cents per unit
Distributions	1.24
Unit value change	14.93
Net earnings result	16.17

Asset allocation



Australian Ethical Balanced Trust

Performance (%)*

	1 year	3 years	5 years	since inception
Trust	9.7	13.7	9.7	8.2
Multisector 60	13.3	11.9	6.3	8.6

Top five holdings

Bendigo Bank Ltd

St George Bank Ltd

Australian Ethical Income Trust

Suncorp-Metway Bank Ltd

Bank of Western Australia Ltd

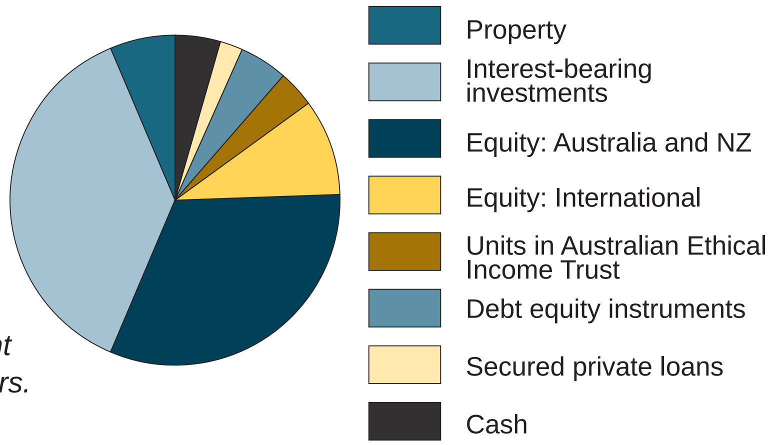
FUND AWARDS 2005 AUSTRALIA WINNER Balanced Funds —Neutral STANDARD &POOR'S

Australian Ethical Balanced Trust - awarded for consistent high performance over 3 years.

Earnings

Full year	cents per unit
Distributions	2.09
Unit value change	5.35
Net earnings result	7.44

Asset allocation



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