australian**ethical**

MANAGED INVESTMENTS half-year update

July to December 31 2008

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investment + superannuation

Investment update

In August 2007 I was working in London and enjoying the late summer when news filtered through that Northern Rock Building Society may be experiencing some liquidity issues. Northern Rock had only a few branches in London, but next day I saw the queues of people around the block waiting for the branch to open to redeem their deposits. Northern Rock was one of the top five mortgage lenders in the UK, and part of the FTSE 100. Within a month the UK Government via the Bank of England nationalised the Bank. This was August 2007 not August 2008 and gave an indication of the trouble brewing in International Markets.

Fast forward to August 2008 and I have taken over the reins as Chief Investment Officer at Australian Ethical. The US economy was in serial decline with mortgage foreclosures rising along with unemployment. Bear Stearns, one of the largest US securities firms, had already been forced into a shotgun marriage with JP Morgan to stave off bankruptcy. So many masthead US and UK securities and banking firms have now folded, been taken over or been nationalised. Wachovia, Merrill Lynch, Washington Mutual and Lehman Brothers in the US. Alliance and Leicester, Royal Bank of Scotland and HBOS in the UK. Locally we have witnessed the largest takeover in Australian history with Westpac buying out St George.

It was when Lehman Bothers filed for Bankruptcy on 15 September 2008, the largest in US corporate history, did markets finally acknowledge the depth of the current crisis and the spider web like impact that failing financial firms would have on the rest of the world. The resulting market sell off during October was one of the sharpest and frenetic that has ever been witnessed.

Australian Ethical has weathered the storm, especially the last six months, exceptionally well. As much as I would like to report that our equities funds delivered positive returns for this period, I can only report that our funds retreated a great deal less than the market and our peers. Our funds have been positioned defensively in industries such as health care and utilities. We have, by virtue of our Charter, avoided the now obvious asset bubble that represented the mining sector and steered a course through the wreckage of highly leveraged company vehicles.

2009 will, in my view, be a story about capital. Access to it, and the price to be paid. We are witnessing banks globally rationing capital and this does not bode well for companies who need to rollover or renegotiate borrowings in the next 12 months. Governments globally, including the Australian Government, have taken measures to restore confidence in the banking system. Companies who cannot borrow from banks or debt capital markets will need to approach shareholders for more funds. This in turn dilutes current share ownership, is an expensive form of capital and contributes to downward pressure on share markets and prices due to the over supply of share capital.

Further pressure will be placed on the fiscal positions of governments as they are asked to participate in capital raisings to maintain jobs and pump prime economic growth. We hope that this strain on budgets will not dent the resolve of governments to create green industry initiatives and jobs. We note that Barack Obama is not retreating from election pledges in this area and recognise the enormous weight on his Presidency. No incoming President, except perhaps for F. D. Roosevelt in the early 1930's, has inherited an economy in such poor health with such high expectations of reform.

For the Australian economy, very high levels of borrowing or gearing tend to bring forward consumption. Companies can afford to bring forward capital spending programs or acquisitions because debt capital is cheap and plentiful. The same is true for the consumer when purchases are brought forward because of the availability and price of credit and the feelings of security that employment brings. I expect that the economy will take a period of time to catch up to the brought forward spending of the last five years. That might take two years, but the good news is that we are already almost 18 months past the late northern summer of 2007 and the first run on a bank in almost 80 years.

Martin Halloran
Chief Investment Officer

Australian Ethical Balanced Trust

The Balanced Trust fell 7.4% over the half year outperforming the -11.9% of its peer benchmark the Morningstar Multi Sector Balanced Group. The broader market S&P ASX 200 index fell by 28.6% over this period.

The Balanced Trust is a 'long only' fund which means that we stay invested in the market and hold prudent levels of cash assets.

The half year started well with positive returns in July through to September. The fall of Lehman Brothers in September and the negative confidence contagion which spread sent markets tumbling in October and November. December provided a much welcomed positive return to finish the year.

The Trust has remained on the conservative side of our allocation to equities and increased its allocation to fixed interest and cash. Our listed property trust holdings proved very disappointing over the half and we sold down our exposure considerably in November and December. Late in the year the converting preference, resettable preference and hybrid securities market, particularly amongst regional banks suffered as the market anticipated new capital raisings coming to market.

Over the six month period, the Trust outperformed its benchmark due to overweight positions in healthcare, insurance and underweight position in major banks.

Top performers

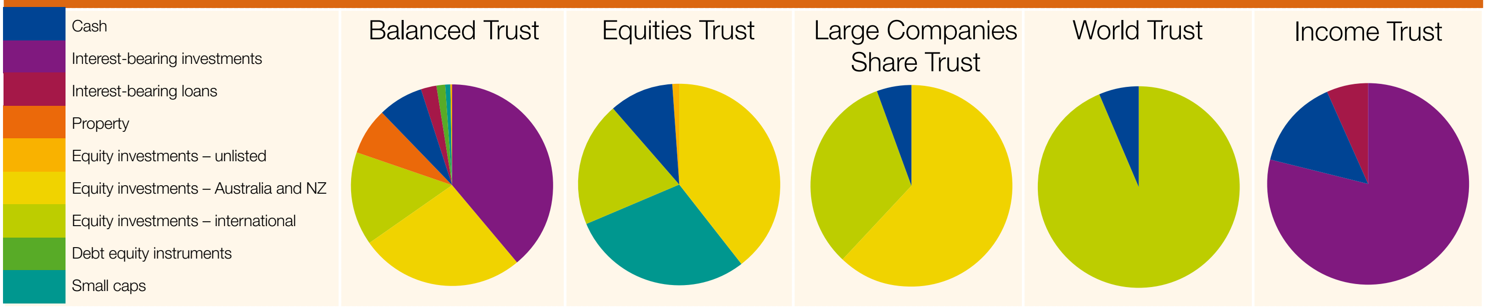
Our best performers were in utilities, healthcare and insurance. Whilst defensive in nature, the companies also had lower gearing or an ability to present to the market that they were able to raise capital through asset sales or joint ventures.

- Respiratory medical device manufacturer ResMed (+47.7%)
- Healthcare safety product manufacturer Ansell (+35.3%)

Returns to 31 December 2008

Trust/ benchmark	6 month return (%)	1 year return (%)	3 year return (% pa)	5 year return (% pa)	10 year return (% pa)	Since inception (% pa)
Balanced	–7.4	–17.7	–1.6	4.4	6.7	6.6
Morningstar Peer Group Retail Investment Trusts Multisector Balanced Index	*–11.9*	*–18.2*	*–1.4*	*4.2*	*4.1*	*6.6*
Equities	–9.6	–21.5	3.4	8.8	9.9	9.1
S&P/ ASX Small Industrials Index	*–30.6*	*–52.7*	*–13.5*	*–0.7*	*1.7*	*–5.1*
Large Companies	–8.8	–27.0	–4.0	6.4	8.6	8.2
S&P/ ASX 200 Industrials Index	*–18.5*	*–39.4*	*–6.3*	*4.3*	*5.1*	*6.7*
World	–17.3	–31.9	–	–	–	–23.6
MSCI World Index (unhedged AUD)	*–9.7*	*–25.8*	–	–	–	*–28.1*
Income	1.2	3.6	4.6	4.7	4.7	4.6
CPI + 2%	*2.8*	*5.8*	*5.4*	*5.1*	*5.2*	*5.0*

Asset allocation



- Hearing implant manufacturer Cochlear (+26.9%)
- Ramsay Healthcare (+19.4%)

Australian Ethical Equities Trust

Over the six month period the Equities Trust fell 9.6%, exceeding the performance of the fund's benchmark, the S&P/ASX Small Industrials Index, which fell 30.6%.

The out-performance in extremely trying equity markets can be attributed to strong relative performances in the Australian equity portfolio. The Trust benefited from holding larger exposures to the healthcare sector, while being underweight financials and having no exposure to the mining sector. At the stock level coal seam gas explorer Pure Energy was a standout performer, appreciating 135 percent over the six months to 31 December 2008.

New investments

- We re-introduced blood plasma company CSL into the portfolio because of its defensive qualities and because it benefits from a weaker Australian dollar.
- We introduced Primary Healthcare into the portfolio on defensive business model and valuation grounds.
- We introduced integrated waste company Transpacific Industries into the portfolio on defensive business model and valuation grounds.

Top performers

- Coal seam gas explorer Pure Energy Resources (+134.8%)
- Hearing implant manufacturer Cochlear (+26.9%)
- Insurer QBE (+15.2%)
- Australian Pipeline Trust (+14.9%)

Australian Ethical Large Companies Share Trust

The Large Companies Share Trust fell 8.8% over the half-year outperforming the –18.5% of its benchmark (S&P/ASX 200 Industrials).

Over the six month period the Trust outperformed its benchmark due to overweight positions in healthcare, insurance and underweight position in major banks.

New investments

Domestic

- Coal seam gas producer Arrow Energy
- Hospital operating group Ramsay Healthcare
- Second tier bank, Bendigo and Adelaide Bank
- Internet job advertising company Seek

International

- Major Spanish bank, Banco Santander
- Itron, a manufacturer of meters and other energy efficiency products
- Genesee & Wyoming which provides rail freight transportation in the Americas and Australia
- Three stock exchanges: Singapore Exchange, Deutsche Boerse and Hong Kong Exchanges

Top performers

The Australasian healthcare sector was by far the strongest sector for our holdings in the half-year contributing all five top performers. This can be attributed to the defensive quality of this sector as well as the substantial fall in the Australian dollar, as these companies all have significant offshore revenues.

- Respiratory medical device manufacturers ResMed (+47.7%)
- Fisher & Paykel Healthcare (+43.2%)
- Healthcare safety product manufacturer Ansell (35.3%)
- Hearing implant manufacturer Cochlear (+26.9%)
- Ramsay Healthcare (+19.4%)

Australian Ethical World Trust

The World Trust directly invests in the Australian Ethical International Equities Trust (wholesale), which makes the actual investments and holds shares in highly ethical companies involved in renewable energy, recycling, public transport, bicycle manufacturing, water management, healthcare and other socially responsible areas.

It was a very rough six months for global investments. Ignoring currency movements global equities declined 34% over the six months from July to December 2008.

For our Trust, currency movements offset some of the large falls. Converting the share price back into Australian dollars the World Trust's underlying shares fell only 15%. This compares to -9.7% for the benchmark MSCI World Index in Australian dollars.

The World Trust underperformed its benchmark primarily due to overweight positions in renewable energy and northern European countries. Renewable energy stocks fell 55% over September and October, and movements in Norwegian, Swedish and Danish kroner were less favourable than the Euro and US dollar dominated MSCI Index.

Monthly returns	World Trust	MSCI (AUD)
July	0.1%	–0.8%
August	8.8%	–8.4%
September	–7.1%	–4.4%
October	–14%	–4.6%
November	–3.3%	–5.2%
December	–1.7%	–3.9%

New investments

- Global stock exchanges; Deutshce Bourse, Hong Kong Stock Exchanges, London Stock Exchange
- Grifols (healthcare, Spain)
- Sims Metal Management (metals recycling, US listing)
- Pentair (US, water technology)

Top performers

- Tokyo Gas (+6%)
- Osaka Gas (+6%)
- Resmed (+5%)

Australian Ethical Income Trust

The Income Trust returned 1.2% compared to its benchmark's 2.8% over the last six months. Opposing influences have contributed to a very volatile fixed interest market. On the one hand, demand has been collapsing, with consequent beneficial effects on inflation, thus central banks have been cutting official interest rates. On the other hand, spreading and greatly increasing levels of financial risk has lead to margins expanding greatly for debt that is not government guaranteed.

We continue to manage the Income Trust with the aims of both reflecting current interest rate levels and constraining the risks attached to such a portfolio. New investments have been concentrated in the shorter end of the interest rate curve, with the aim of remaining cautious until the market settles down.

Past performance is not a reliable indicator of future performance.

Performance figures are calculated using exit prices. Performance figures take into account ongoing management fees and trust expenses. Performance figures are calculated as if distributions of income have been reinvested. They do not take into account tax that may be payable on the distribution of income. Neither the return of capital nor the performance of a trust is guaranteed. Figures showing a period of less than one year have not been adjusted to show an annual return. Figures for periods of greater than one year are on a per annum compound basis.

The latest available performance figures can be obtained from our website **www.austethical.com.au** or by calling **1800 021 227**. Units in the trusts are offered and issued by Australian Ethical Investment Ltd ABN 47 003 188 930, AFSL 229949. A product disclosure statement is available from our website or by phone and should be considered before deciding whether to acquire, or continue to hold, units in the trusts. This information has been prepared without taking account of your individual investment objectives, financial situation or needs. Before acting on it, you should consider its appropriateness to your circumstances.

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