

australian**ethical**

MANAGED FUNDS half-year update

July to December 31 2009



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australian**ethical**
investment + superannuation

Investment update

Dear Investors,

All funds post positive returns

All our funds delivered positive investment returns in the six months ended 31 December 2009. I am happy to communicate this good news as it is a complete turnaround in the fortunes of the market compared to the last half of 2008 and the very dismal news I had to deliver in my report at that time.

Australia avoiding recession has helped the local share market to rebound quickly. Progressive interest rate hikes, the return of inflation to the RBA target band and the unemployment rate not hitting the dire prediction of 8.5% are all markers of an economic recovery.

Over the six months, our relative investment performance suffered mostly in the September quarter due to our underweight positions in both materials (mining stocks) and the big four banks versus the market and our peers. In many ways the easy gains from the rising tide of the share market have been made. Individual stock selection is now the most important factor differentiating fund performance and our investors have benefited from a number of individual stock calls made by our investment team over the period. Our investments in information technology and biotechnology stocks have far exceeded the market return over this period and have helped us deliver strong investment returns in the December quarter.

Copenhagen and renewable energy investment

Failure at Copenhagen to secure a global agreement on emissions was disappointing but did not severely impact our renewable energy investments around the world. In Australia at least, legislation confirming the Renewable Energy Target was passed and funding from the Department of Resources, Energy and Tourism as part of the \$235 million Renewable Energy Demonstration Program, directly benefited our investments.

Global Smart Energy

From January 2010 the International Equities Trust will be repositioned to focus on Global Smart Energy. The fund will target investment in companies involved in global sustainable energy supply and demand. This dual focus will allow the fund to benefit from the opportunities presented in combating and managing the impact of climate change. The fund will provide specialist exposure to renewable energy supply through sources such as wind, solar and geothermal, as well as exposure to efficient and adaptive technologies in areas such as electric vehicles, recycling and smart grid systems. This repositioning will enhance the sustainability profile of the fund and allow for greater access to sustainable returns from this long-term theme.

Looking up, but cautious on overseas economic recovery

Our market outlook is positive, but a little guarded. The Australian market looks good with consumer spending, private sector investment and export driven demand keeping company earnings buoyant. However, we can see capacity constraints in the Australian economy starting to rise again with large energy infrastructure projects driven by Chinese demand. We are still concerned about the US economy as it faces a tough year negotiating on health care reform and emissions trading legislation. The US is not the same economy that it was two years ago and may not be for some time. It has a lasting legacy of 10% unemployment, still high property foreclosure rates and the winding back of fiscal stimulus in the first half of 2010. We are also concerned about the effect of stimulus spending in China and the obvious over capacity in this country now being reigned in by its government. It all points to a year where we will be paying close attention to the overseas economic recovery and looking for signs of any sustained economic weakness flowing through to company earnings.



Martin Halloran
Chief Investment Officer

[We welcome queries and feedback on the ethical dimensions of our investments.](#)

Fund commentaries

Australian Ethical Balanced Trust

The Balanced Trust returned 6.5% over the half-year to 31 December 2009. This marks a huge turnaround from the previous corresponding period. The Australian share market began its long turnaround in March 2009, posting some very substantial gains. However the overall market is still some 40% below the high point set in late 2007.

The Balanced Trust has remained conservatively invested with domestic and international shares representing 45%–50%, property 5–10% and interest bearing investments making up 40–50% of the overall portfolio.

The Balanced Trust underperformed the broader market index on two main fronts. Firstly, a lack of investment in core mining, metals and oil companies. Secondly, having little exposure to the Big 4 Banks (we currently only invest in regional banks and Westpac). Both of these sectors performed very well over the last six months.

The fund increased holdings of Australian residential mortgage-backed securities rated AAA as these investments are still paying an attractive risk adjusted yield.

The outlook for the fund remains positive as the earnings quality of our companies becomes better recognised by the market. The challenge will be to ensure the fund is positioned in companies that have sustainable businesses that are leveraged to the global economic recovery.

New investments

- Telstra Corporation (Australia)
- IRESS Market Technology (Australia)

Top performers

- Bendigo and Adelaide Bank (+41.6%)
- Suncorp Metway (+29.7%)
- QBE Insurance (+28.6%)
- Australian Pipeline Trust (+27.3%)
- Computershare (+26.9%)

Worst performers

- Sims Metal Management (-16%)
- Ramsay Health Care (-5.6%)

Australian Ethical Smaller Companies Trust

The Smaller Companies Trust (previously named the Equities Trust) returned 16.5% over the six months to 31 December 2009, compared with 28.3% for the benchmark.

The fund's holdings in larger Australian companies performed in-line with their index. The fund's smaller companies and international investments underperformed their respective indices. However, the fund's relative performance against the benchmark remains strong over two and three year periods.

This under-performance can be attributed to the fund being overweight in defensive stocks in the healthcare and utilities sectors. Companies with highly defendable profit streams including Cochlear, Fisher & Paykel Healthcare and Origin Energy strongly outperformed when the market was depressed. However, these stocks then underperformed after markets started rallying in March 2009. Green energy retailer Jackgreen went into administration over the month of December.

The fund exchanged 11 directly held international holdings in return for units in the Australian Ethical International Equities Trust. This fund has been repositioned with a Global Smart Energy focus.

Rebounding share markets have seen companies re-rated on the premise their earnings will quickly rebound in 2010. 2010 looks to be a challenging year as the easy money has already been made. The most compelling value is in the smaller and micro-cap companies. We view 2010 as a year when fundamental stock valuations in combination with timely stock picking will beat the market.

New investments

Domestic small

- QRX Pharma (Australia)
- Macquarie Telecom (Australia)
- Panax Geothermal (Australia)
- Tissue Therapies (Australia)
- Dexion (Australia)

Top performers

- Amcom (+75%)
- Energy Developments (+36%)
- Hansen Technologies (+57%)
- Genera Biosystems (+50%)

Worst performers

- Jackgreen (-100%)
- Viridis Clean Energy (-32%)
- Sigma (-19%)
- Sims Group (-16%)

Australian Ethical Larger Companies Trust

The fund returned 13.4% over the half-year compared to 21.2% for the benchmark.

The strong return was largely driven by the fund's domestic holdings. A strengthening Australian dollar detracted significantly from international returns.

The underperformance against the benchmark is largely attributed to the overweight positions in domestic healthcare and international utilities, and being underweight in domestic financials.

Fund commentaries

continued

There was a rapid market shift from defensive stocks into cyclical and financial stocks as it became apparent that the world was not moving into a global depression. The portfolio was positioned for a market rebound by taking increased exposure to cyclical stocks, however the positive impact on relative returns was muted due to its natural biases (overweight healthcare and underweight financials).

Global share markets have had a huge rally since March last year. It is anticipated that 2010 will be more mixed, as many stocks appear fully valued.

The fund's overweight position in healthcare and utilities should perform well if the market takes on a more defensive mood as appears to be happening so far in 2010.

In December, the fund exchanged its 31 international investments in return for units in the Australian Ethical International Equities Trust. This fund has been repositioned with a Global Smart Energy focus.

New investments

- Telstra - Australia
- SMA Solar Technology - Germany
- IRESS Market Technology - Australia
- Transpacific Industries - Australia
- Pharmaxis - Australia

Top performers

- SMA Solar Technology (+69%)
- Seek (+65%)
- Macquarie Office Trust (+48%)
- Fairfax (+43%)
- Bendigo and Adelaide Bank (+42%)

Worst performers

- Vestas Wind Systems (-23%)
- SunPower (-22%)
- Gamesa (-20%)
- Sigma Pharmaceuticals (-19%)

Australian Ethical International Equities Trust

Over the last six months, global markets have continued to bounce back from the March 2009 lows. The materials, consumer discretionary and information technology sectors have led the recovery. In US dollars the global market has bounced 74% since bottoming in March 2009. However, the Australian dollar has also strengthened translating into a 22% gain in AUD.

The fund benefitted from continued strength in US cyclical stocks including Whole Foods Markets, VMWare, Citrix and Interface. The standout was SMA Solar, a German company specialising in manufacturing electrical inverters associated with solar panels. This niche player has a dominant market share, supplying many panel manufactures and installers.

Whilst the fund benefitted in the first half of 2009 from its relatively defensive utility and healthcare holdings, this was reversed in the last six months. These stocks did not see the rebound that the more consumer exposed sectors did.

Renewable energy stocks also underperformed. Already faced with large falls in orders for wind turbines and solar panels globally, these stocks were hit with increasing competition from Chinese companies, and failures at a political level.

Despite these short-term challenges, we believe the next few years will represent a turning point in the shift toward renewable generation, alternative fuels and transport, energy saving and recycling.

australian**ethical** is enhancing the sustainability profile of the fund with a repositioning to focus on Global Smart Energy.

This will see the fund have a greater focus on both the supply and demand side of global sustainable energy. This approach will provide investors with exposure to renewable energy supplies such as wind, solar and geothermal, and also to efficient and adaptive technologies like electric vehicles, recycling and smart grid systems. We believe this focus will enable investors to capture opportunities presented in combating and managing the impact of climate change.

Top performers

- SMA Solar (+69%)
- Impax Asset Management (+50%)
- Storebrand (41%)
- VMWare (40%)
- Getinge (31%)

Worst performers

- Vestas Wind Systems (-23%)
- SunPower (-22%)
- Gamesa (-20%)
- Solarworld (-16%)
- Ormat Technologies (-15%)

Fund commentaries

Australian Ethical Income Trust

The return for the Income Trust over the half-year was 2.7% against the benchmark return of 1.8%.

The short-dated and floating rate investments of the fund have benefited from increasing interest rates. The fund purchased some new short-dated fixed rate investments including Telstra (A-rated) and Snowy Hydro (BBB+).

The fund has maintained the level of holdings in AAA rated Australian conforming residential mortgage-backed securities over the half at 21%, participating in new issues from Westpac and Suncorp.

The fund lifted holdings in a diverse range of term deposits from 27.1% to 34.4% by adding deposits with Newcastle Permanent Building Society, CUA and Members Equity. All our term deposits are covered under the government's Deposit Guarantee.

The fund will continue to seek out term deposits guaranteed under the financial claims scheme, with the expectation the guarantee will remain over 2010.

We anticipate further rises in the official rate in the early part of 2010, though expectations are of a return to an official cash rate below the previous neutral rate of 4.75%. The fund is positioned to take advantage of any increase in rates.

Australian Ethical Property Trust

The Property Trust was seeded in June 2009 and returned 4.1% over the six months to 31 December 2009, its benchmark returned -0.6% (Mercer Unlisted Property Fund Index).

The current portfolio of the fund comprises a 5 Star Green Star rated commercial building in the Canberra CBD and units in an unlisted property trust.

The fund is currently geared at 32%. The loan with NAB is hedged with an interest rate cap on the bank bill rate at 5% (currently 4.23%) until June 2014.

The portfolio wide occupancy rate is 96.6%. There is only a small amount of vacancy left in the Canberra property and that is currently under negotiation.

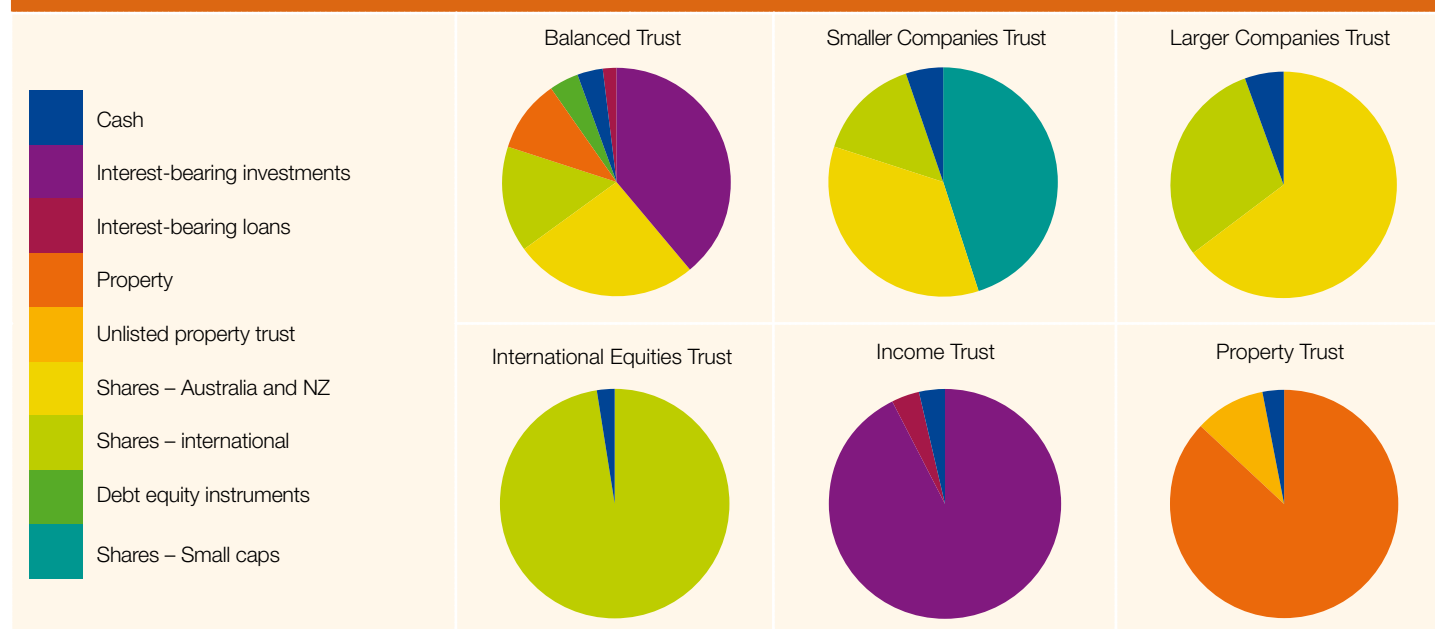
The fund is actively seeking new investment opportunities across major metropolitan areas in Australia.

Returns to 31 December 2009

Trust/ benchmark	6 month return (%)	1 year return (%)	3 year return (% pa)	5 year return (% pa)	10 year return (% pa)	Since inception (% pa)
Balanced	6.5	8.9	-2.1	2.6	6.1	6.7
Morningstar Multisector Balanced Index	12.1	11.3	-1.5	3.7	4.5	6.8
Smaller Companies	16.5	26.2	5.0	9.5	8.6	10.2
S&P/ASX Small Industrials Index	28.3	44.9	-9.6	1.6	3.0	6.9
Larger Companies	13.4	12.8	-4.6	3.4	6.1	8.6
AELT Merged*	21.2	22.3	-5.8	3.4	3.6	6.5
International Equities	4.3	2.0	-	-	-	-12.3
MSCI World Index (unhedged AUD)	10.2	2.7	-	-	-	-11.2
Property	4.1	-	-	-	-	-7.6
Mercer Unlisted Property Fund Index	-0.6	-	-	-	-	-6.0
Income	2.7	4.9	4.6	4.8	4.9	4.6
Australian 90 day bank bill	1.8	3.5	5.8	5.9	5.6	5.6

* 65% S&P/ASX 200 Industrials and 35% MSCI World Index

Asset allocation



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.australianethical.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. Australian Ethical® is a registered trademark of Australian Ethical Investment Ltd.