australianethical
investments

Year In Review

An update from Australian Ethical

Like all financial services companies, Australian Ethical continues to face a world that has fundamentally changed. We are now in the fifth year of the global financial crisis, markets continue to be down significantly from their peak, investors globally continue to be nervous and regulatory change is fundamentally altering the structure of the financial services industry.

In the face of this, we have been investing significantly to improve our products, systems, client service and investment processes to meet and exceed the service standards required to operate in the market. Over the past few years we have achieved a lot and this has set Australian Ethical up for a sustainable, long-term future.

It is also important to stress what hasn't changed. We remain the fund manager with the highest ethical conviction in the market. It is what we are known for amongst all else. Our divestment last year from Origin Energy, because of its exposure to coal seam gas, is evidence of our continued willingness to take a stand on key ethical issues.

Australian Ethical has 25 years of investing ethically under its belt. We have made the world a better place by only investing in companies, products and services that create positive change for society whilst meeting our strict investment criteria. It is our core belief that we can all enjoy financial security whilst leaving a positive legacy for our children and grandchildren.

Please enjoy this new look investor newsletter specifically tailored for managed fund clients.

Yours faithfully

Phil Vernon
Managing Director

In this issue...

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Volatility makes stock selection the key

The Australian sharemarket (as measured by the S&P/ASX 200 Index) lost ground in the 12 months ending 30 June 2012, with a return of negative 11.1%. Not all sectors fared equally as can be seen in the chart below. 'Cyclical' sectors such as Metals & Mining (-32.5%), Energy (-21.1%) and IT (-11.4%) were shunned in favour of 'defensive' sectors, like Telecommunications (+27.3%), Utilities (+10.3%) and Health Care (+8.1%).

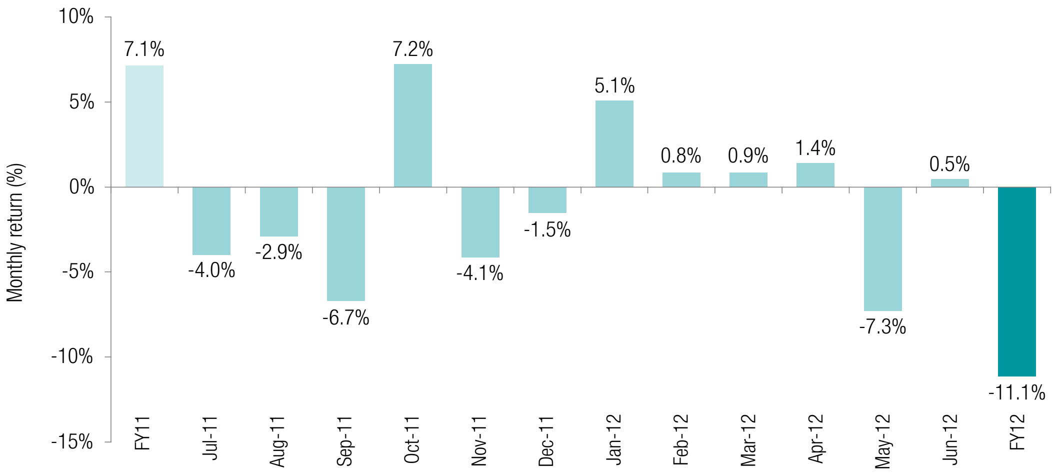
Various indicies returns in FY11 and FY12

While the broader market fell 11.1% over the year, month-by-month movements were pronounced (as shown in the chart on page 3) swinging from positive 7.2% for the month of October 2011 to negative 7.3% in May 2012.

Much of this can be traced to constant shifts in investor sentiment, driven in part by economic events such as the European Union's ability to navigate its sovereign debt crisis. Events in Greece and Spain in particular were of deepening concern over the year, although the recent Greek elections brought some investor relief, with the centre-right New Democracy fending off a challenge by the anti-austerity party Syriza. Additionally, concerns about weak US jobs data and China's reported weaker growth in Gross Domestic Product, and import and export growth contributed to the volatile markets.

In Australia, the Reserve Bank of Australia cut the official cash rate on four occasions during the year (November, December, May and June) by a total of 1.25 per cent. The moves were in response to weaker than expected economic conditions and by financial year end the official cash rate stood at 3.5%. With ongoing funding pressure on Australian banks and intense competition for deposits, the banks only passed on part of the rate relief to consumers and businesses.

ASX 200 returns by month in FY12



Our view

In order to stimulate the non-mining related sectors of the Australian economy, especially housing and construction, manufacturing, education and tourism industries, which have continued to struggle, it is our view that a continued easing of monetary policy will be necessary.

Interestingly, while the domestic economy can be best described as a 'two-speed economy' – characterised by a booming mining industry in Western Australia and Queensland – the share prices of resource stocks have fared much worse than the broader market – down 32.5% for the year, reversing the previous year's 18.9% gain.

Australian Ethical Investment's Funds do not hold mining resources stocks as they do not fit The Charter. Instead, investments are skewed towards an exposure to defensive industries. As a result, our domestic equity portfolios have outperformed the broader market index over the year ending 30 June 2012.

While there really is nowhere for our equity funds to 'hide' in uncertain times, they have minimal exposure to companies with direct activities in the troubled European economies or that are reliant on discretionary consumer spending. Our healthcare investments such as Cochlear and CSL will continue to see demand for their products irrespective of what happens in Greece, our biotechs such as Alchemia and Pharmaxis continue to develop exciting new treatments for diseases, and our telco & IT companies like Oakton and SMS will continue to offer their in-demand services to domestic businesses.

We continue to place a greater emphasis on quality companies with robust business models, manageable debt position and trustworthy management. Our biotech names are mostly in the latter stages of clinical development with commercialisation typically expected in the next one to two years, and we are selectively pursuing new opportunities where we see compelling value.

David Macri
Chief Investment Officer
Australian Ethical Investment

New investments – GT Advanced Technologies

GT Advanced Technologies (NASDAQ listed – ticker GTAT) produce a range of production equipment and engineering packages that are used in the solar, LED and other speciality industries.

The Australian Ethical Charter sees the development of appropriate technology systems as a positive activity. Specifically, the development of renewable energies that can help mitigate the global problems of climate change, energy supply and energy security.

Nearly all of GT's revenue is derived from its Photovoltaic business segment. This segment produces machines that are used to manufacture polysilicon, the key feedstock for the solar and semiconductor industries, as well as machines that are used to produce multicrystalline ingots, solar wafers and solar cells, the essential components of solar panels.

The Company also manufactures equipment used in the production of Light Emitting Diodes (LEDs). As LEDs are significantly more energy efficient than competing technologies, they are being used increasingly.

There are a couple of areas of concern in the business (noted below) that we will continue to monitor although, currently, we are satisfied they are being managed appropriately:

- Some of GT's manufacturing machines are used to produce polysilicon for semiconductors. Generally electronics products are energy-intensive to manufacture and use, and have a negative environmental impact. The Company states its CVD reactors, used to make polysilicon, are the industry's "most productive and energy efficient".
- GT is also exposed to human rights concerns as it has operations in China. However at this stage, there are no reports that the Company has been involved in any human rights abuses.

Investments in GTAT are held by Australian Ethical's International Equities Trust and Larger Companies Trust.

Web: gtat.com

HiCz™ Equipment used for developing high quality, advanced monocrystalline material.

Special offer for Australian Ethical investors

Join GoGet, Australia's leading car sharing service, to get all the benefits of a car without the hassle or expense of owning one. For every GoGet car, nine private cars are taken off the road, which contributes to making our cities more livable.

Offer

As an Australian Ethical investor, when you sign up to GoGet you will receive a $50 driving credit. Simply enter the code 'AEI50' in the promo code field on the application form.

To sign-up, simply register at goget.com.au

Coal seam gas dilemmas and responsible investment

The natural gas industry has traditionally been supported by responsible investors mainly because modern Australian gas-fired power plants, known as ‘combined cycle’ units, emit approximately half the greenhouse gas emissions (GHG) of coal-fired power generation.

In addition, in the current electricity transmission infrastructure environment, gas-fired power complements renewable energy generation, offering a comparatively low emission back-up energy source for those times when the intermittent nature of solar and wind power leads to supply shortages.

Given the GHG advantages of conventional natural gas over coal, there are clear ethical attractions to using the large resources of methane trapped in deep coal seams in Queensland and New South Wales – coal seam gas.

Unfortunately things aren’t quite as straightforward as that.

Australian Ethical and Origin Energy

The rapid and large scale development of the coal seam gas industry puts responsible investors in a dilemma – how to balance the GHG benefits of coal seam gas (compared to coal), versus the potential environmental and community impacts caused by its extraction. The weaker the GHG advantages, the more questions responsible investors will ask around the overall benefits.

When Australian Ethical started reviewing our approach to coal seam gas (CSG), our only direct exposure was through Origin Energy (ASX: ORG) and its Australia–Pacific liquid natural gas project. Our initial support of Origin was driven by the Company’s strong focus on natural gas-based electricity generation, renewable energy investments and GreenPower program. These attractions remain and we’re confident that overall Origin is a responsible and well-managed company.

Australian Ethical, along with our environmental and social governance research partner CAER, had been monitoring the ethical issues, and as the industry has seen a rapid scaling-up, we augmented our ethical Charter evaluation with the development of a risk evaluation methodology specifically for CSG.

This approach aims to properly understand each of the risks and benefits created by the coal seam gas industry and to establish how well companies, and the industry as a whole, are able to manage these risks. One issue is that regulators are focussing on per-company environmental impact assessments and so neglect the broader question – what will be the cumulative impact of the industry as a whole?

The practice of hydraulic stimulation of CSG wells (fraccing) has been the main focus of media attention and the potential for pollution of local aquifers is no doubt the most immediate concern of farmers and landowners. These are serious risks, but can arguably be controlled if companies manage well integrity and ensure fraccing liquids do not contain carcinogenic and other toxic chemicals. Additionally, not all coal seams require fraccing to stimulate gas flow, reducing local risks to some extent.

All that salty water

Incidents over the last year show that investors need to ask serious questions about how companies are managing their operations in relation to produced water. The spill of untreated water due to a pipeline failure at Eastern Star Gas (now Santos ASX: STO) operations in the Pilliga State Forest allegedly resulted in surrounding trees and scrubs dying. In Queensland, discharge allowances from Origin Energy’s reverse osmosis plant were under attack recently when treated water was released into the Condamine River. While safe for human consumption under drinking water guidelines, it was alleged to have unsafe levels of boron and cadmium for freshwater organisms.

Companies are able to manage these risks through applying rigorous environmental governance matched with appropriate community consultation. To date, however, there is scant evidence of a workable plan for dealing with the large amount of waste brine and salt produced once coal seam gas projects are fully operational. This creates a large liability for the coal seam gas industry and the environment.

Continued over page

Companies are investigating options for the reinjection of produced water to avoid these problems, but to date this has not be shown to be commercially viable, and regulators are not mandating such measures.

CSG extraction involves the removal of large volumes of water from deep coal seams. The rapid and large scale development of coal seam gas across Queensland and parts of New South Wales poses difficult questions for industry and regulators around the cumulative impact of large-scale water extraction.

There are calls from concerned groups for a slower rate of industry development that would allow thorough studies into the potential impacts on the Great Artesian Basin, one of Australia's largest sources of groundwater water.

While there is extensive knowledge around the structure and formation of coal seams, there remains uncertainty about the permeability and interconnectedness of coal seams and groundwater resources. CSG critics point to concerns that extracting large volumes of water from a coal seam may result in pressure differentials with surrounding water-bearing seams, resulting in potential drops in water levels and contamination of aquifers.

Australian Ethical's Chief Investment Officer, David Macri says "meetings with CSIRO reassured us that our analysis and understanding of the issues was on the mark, but also confirmed our concerns about the long-term impacts of large-scale water extraction on the Great Artesian Basin."

With negative impacts that are potentially irreversible, or at least would take lifetimes to reverse, we are concerned about any company's capacity to appropriately manage this risk. Origin Energy was divested in late 2011, thus ending our exposure to the CSG sector.

Australian Ethical continues to believe that natural gas will play an important role in the transition away from polluting coal-based energy. It retains investments in natural gas-fired power generation and associated infrastructure assets. Our flagship fund, the Australian Ethical Smaller Companies Trust, invests in Energy Developments (ASX: ENE), which generates low emissions power from waste gas. In addition, some of our Funds currently include investments in the owners and operators of gas transmission and distribution pipelines, with good examples being Envestra (ASX: ENV), APA Group (ASX: APA) and Duet Group (ASX: DUE).

Risman Cornelius

(Investment Analyst, Australian Ethical Investment)

Julia Leske

(Senior ESG Analyst, CAER)

New Investments - Avita Medical Limited

avita medical

Avita Medical (dual listed on the Australian Securities Exchange: ticker AVH and U.S. Exchange OTCQX: ticker AVMXY) is a biotechnology company that develops and distributes products in Regenerative and Respiratory Medicine.

ReCell and CellSpray are regenerative, tissue-engineered products used for treating wounds, burns, scars and skin defects. A patient's own skin cells are grown in a culture and used to create a "spray-on" treatment to areas of damage that skin grafts have traditionally been used for. Speed is the key advantage of these products. ReCell can be applied to serious wounds and burns in as little as an hour, which means the chances of successfully healing the wound increases and the probability of scarring decreases.

The Company is also the leading provider of spacers for the paediatric, adolescent and adult market in Australia. Spacers are like large plastic tubes, which are used in conjunction with asthma inhalers, to improve medication delivery to patients suffering from chronic respiratory diseases.

Avita's activities support tenet (h) of the Australian Ethical Charter - human happiness, dignity and education.

There are two areas of the business that give rise to concerns under The Charter. The Company generates revenue from the sale of ReCell to defence clients and the likelihood that at some stage, the Regenerative products were tested on animals. Both are considered to be minor negatives.

Investments in Avita are held by Australian Ethical's Smaller Companies Trust.

Web:avitamedical.com

Avita medical markets ReCell and Cellspray products.

Managed Funds Profiles

Balanced Trust

Investment objective

To provide investors with a balance between capital growth and a moderate level of income through a diversified portfolio of assets that supports the Australian Ethical Charter.

Recommended minimum investment timeframe

5+ years

Returns to 30 June 2012 (after fees and expenses)

	3 months (%pa)	1 year (%)	3 years (%pa)	5 years (%pa)	10 years (%pa)	Since inception (%pa)
Balanced	-1.9	0.2	2.8	-1.6	4.5	6.1
Morningstar Multisector Balanced	-1.2	0.9	6.3	0.0	4.7	6.6

Significant performers

Best	Worst
Australian Capital Territory Indexed Annuity Bond. A long duration bond that benefitted when yields fell considerably from 3.3% to 2.4%. **Telstra Corp. Ltd.** Regulatory certainty greatly improved. The NBN agreements were signed and the ACCC approved the revised structural separation undertaking, making Telstra's fully franked dividend yield increasingly attractive. **Electranet Capital Indexed Bond.** Benefitted from the fall in yields.	**Sims Metal Management Ltd.** A cyclical business, that issued a profit warning in May 2012 as it struggled to generate acceptable US scrap metal margins. In the absence of clear earnings guidance and with low visibility, the market has assumed the worst. **First Solar Inc.** Solar stocks performed poorly in FY12 as retreating government funded subsidy support, industry overcapacity and falling product prices severely decreased industry profitability. **SMA Solar Technology AG.** *Refer commentary above on First Solar Inc.*

Smaller Companies Trust

Investment objective

To provide long-term growth focusing on Australian companies that meet the Australian Ethical Charter.

Recommended minimum investment timeframe

7+ years

Returns to 30 June 2012 (after fees and expenses)

	3 months (%pa)	1 year (%)	3 years (%pa)	5 years (%pa)	10 years (%pa)	Since inception (%pa)
Smaller Companies	-7.4	-4.2	3.6	-1.2	7.7	8.4
S&P/ASX Small Industrials	-8.6	-2.7	7.5	-9.2	5.1	5.7

Significant performers

Best	Worst
Avita Medical Ltd. Performed strongly as regenerative medicines gained greater attention globally. **Transpacific SPS Trust.** Strong performance after the Transpacific ordinary shares conducted an equity raising, which reduced the risk in this hybrid security. **Amcom Telecommunications Ltd.** As the defensive nature of telco's dark fibre business was recognised by the market, the stock has performed strongly.	**Sims Metal Management Ltd.** *See Balanced Trust.* **Tissue Therapies Ltd.** The biotech performed poorly after disappointing partnering outcomes and delays in commercialisation. **Oakton Ltd.** IT services company performed poorly after its profit margins were reduced in 2012.

Larger Companies Trust

Investment objective
To provide long-term growth through investment in listed companies on the Australian and international stock exchanges that meet the Australian Ethical Charter.

Recommended minimum investment timeframe
7+ years

Returns to 30 June 2012 (after fees and expenses)

	3 months (%pa)	1 year (%)	3 years (%pa)	5 years (%pa)	10 years (%pa)	Since inception (%pa)
Larger Companies	-4.6	-6.3	-0.7	-6.4	4.1	6.0
Melded Benchmark Index	-1.5	2.5	7.1	-4.5	3.8	5.5

Significant performers

Best	Worst
Telstra Corp. Ltd. *See Balanced Trust.* **CSL Ltd.** Defensive assets returned to favour in FY12. CSL's blood plasma and vaccine products cater to urgent medical needs, offering investors comfort that demand will continue, not withstanding increasing economic uncertainty. **APA Group.** Falling bond yields and the RBA cuts to the cash rate increased the appeal of yielding investments such as APA, which owns a large portfolio of gas transmission and distribution assets with relatively stable cash flows and reliable dividends.	**Sims Metal Management Ltd.** *See Balanced Trust.* **Fairfax Media Ltd.** Fell due negative sentiment toward traditional print media assets, culminating in a well–publicised restructuring, and a public disagreement between a substantial shareholder and the Company's board. **First Solar Inc.** *See Balanced Trust.*

International Equities Trust

Investment objective
To provide long-term growth through investment in international companies, which meet the Australian Ethical Charter.

Recommended minimum investment timeframe
7+ years

Returns to 30 June 2012 (after fees and expenses)

	3 months (%pa)	1 year (%)	3 years (%pa)	5 years (%pa)	10 years (%pa)	Since inception (%pa)
International Equitiess	-5.8	-18.1	-7.8	-11.3	n/a	-11.6
MSCI World Index (AUD)	-3.5	0.0	3.1	-6.0	n/a	-5.9

Significant performers

Best	Worst
Cooper Industries PLC Cl A. Benefitted from a friendly takeover by Eaton Corp. **LKQ Corp.** The leading supplier of alternative parts to the car market. It has benefitted from the weak US economy as drivers spend more on replacing parts instead of buying a new car. **Shimano Inc.** Expanding Chinese affluence drove earnings growth for this leading bicycle parts supplier as consumers become more discerning about product choice.	**First Solar Inc.** *See Balanced Trust.* **SMA Solar Technology AG.** *See Balanced Trust.* **Power-One Inc.** Solar stocks performed poorly in FY12 as retreating government funded subsidy support, industry overcapacity and falling product prices severely decreased industry profitability.

Climate Advocacy Fund

Investment objective

The Climate Advocacy Fund is an index fund, which targets returns in excess of the broader sharemarket as measured by the S&P/ASX 200 Accumulation Index.

Recommended minimum investment timeframe

1 year

Returns to 30 June 2012 (after fees and expenses)

	3 months (%pa)	1 year (%)	3 years (%pa)	5 years (%pa)	10 years (%pa)	Since inception (%pa)
Climate Advocacy	-4.6	-4.9	n/a	n/a	n/a	0.4
S&P/ASX200	-4.7	-6.7	n/a	n/a	n/a	-0.9

Cash Trust

(formerly Income Trust)

Investment objective

The Cash Trust aims to generate a competitive income stream while minimising the risk of capital loss and supporting the Australian Ethical Charter.

Recommended minimum investment timeframe

1 year

Returns to 30 June 2012 (after fees and expenses)

	3 months (%pa)	1 year (%)	3 years (%pa)	5 years (%pa)	10 years (%pa)	Since inception (%pa)
Cash	1.0	4.4	4.9	4.6	4.8	4.6
Australian 90 day bank bill	0.9	4.5	4.6	5.2	5.4	5.4

Property Trust

(Closed to new retail investors)

Investment objective

To provide long-term capital growth and moderate income via investment in direct property and listed and unlisted property trusts, in accordance with the Australian Ethical Charter.

Recommended minimum investment timeframe

5+ years

Returns to 30 June 2012 (after fees and expenses)

	3 months (%pa)	1 year (%)	3 years (%pa)	5 years (%pa)	10 years (%pa)	Since inception (%pa)
Property	3.0	9.4	8.1	n/a	n/a	3.7
Mercer Unlisted Property Fund Index	1.9	9.5	8.4	n/a	n/a	6.2

Client service and product news

Australian Ethical has implemented a number of significant changes to product structure and pricing.

Fees and other costs

- Switch fees are no longer charged; and
- The management fee for the Cash Trust (formerly the Income Trust) has been reduced to 0.45%pa (previously 1.13%pa).

Strategic asset allocations

- The Smaller Companies Trust will no longer have an international equities exposure, meaning investments will only be in Australian listed companies.

Minimum investment

- The International Equities Trust now accepts a minimum investment of $5,000 like our other retail Trusts.

Trusts on offer

- The Property Trust is no longer available to retail investors. Existing investors will retain their units.

New 'short-form' Product Disclosure Statements (PDS) were issued on 22 June 2012 for each Managed Fund as required under regulatory changes. These, along with updated Managed Fund forms, are available on our website or in hard copy on request and supersede the previous PDS documents.

Trust Distributions

Fund	JUN 2012	DEC 2011
	Cents per unit	
Balanced	1.9483	0.9231
Smaller Companies	1.9027	0.8969
Larger Companies	1.1022	0.6038
International Equities	–	–
Climate Advocacy	2.3815	0.8070
Cash	2.6451	1.7661
Property	–	–

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Past performance is not a reliable indicator of future performance. Total returns are calculated using exit prices. Total returns take into account ongoing management fees and trust expenses.

Total returns 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 total return. The latest available performance figures can be obtained from our website or by calling 1800 021 227.

Units in the Trusts are offered and issued by Australian Ethical Investment Ltd ('AEI') ABN 47 003 188 930, AFSL 229949. The relevant PDS should be read before making an investment decision.