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.

Please enjoy this new look newsletter specifically tailored for superfund members.

Yours faithfully

Phil Vernon
Managing Director
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.
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 (in which the Super investment options invest) 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
Member Profile – Warren Saunders

Plants ready for dispatch
Geoff West Nursery Manager

10 million reasons ACT is the bush capital

Australian Ethical Super member and employer, Warren Ganter Saunders, the Director of Seeds and Plants Australia has been collecting, growing and planting native and exotic plants since 1988. Warren and his team’s work was recently profiled in The Canberra Times.

Warren Saunders and his nursery staff at Seeds and Plants Australia are Canberra’s secret gardeners, responsible for creating much of the city’s landscape that’s taken for granted.

Leafing through his company’s job records recently, Mr Saunders crunched the numbers and discovered Seeds and Plants Australia, his native plant production nursery in Pialligo, has supplied more than 10 million native plants and over 10 tonnes of native seed for revegetation, landscaping and agro-forestry projects. These range from mine site rehabilitation works in remote areas to Canberra’s roadside verges and embankments and local Landcare projects. “We’ve probably done a lot more, but I stopped counting at 10 million,” he says.

They’ve planted 350,000 seedlings to create 150 hectares of saltbush fodder plantations, and have literally gotten “down and dirty” in the Mitchell urban wetlands, to plant 150,000 native shrubs, grasses, and wildflowers. Coonamble Shire Council had them plant 3,500 trees, shrubs and grasses for their carbon abatement program. For a single revegetation project in the Brindabellas, they collected 900kg of native seed — and that’s just for the understorey planting.

Mr. Saunders, a Gungarri from the western Darling Downs in Queensland, said “I grew up in a big Aboriginal family, so interest in the bush, in native plants, was always there. I love botanising, going bushwalking to find plants and seeds.”

Mr. Saunders grows bush tucker foods, and teaches didgeridoo at the Australian National University. He makes didgeridoos from material collected from the bush (“You look for gum trees and termites,”) and Irish band Hothouse Flowers and British singer Sting both have instruments he’s crafted.

He jokes that we need to “get away from the old-school Pommy view of green lawns and exotics” when designing urban landscapes, and experiment with native plants. “Councils plant exotic grasses on road sides and in urban parks, then spend a small fortune on mowing to keep the fire risk down … All the mowing does is spread more weeds, and keep pushing the costs up. But native grasses don’t grow as high, so fire risk and mowing bills go down, and biodiversity goes up.”

Mr. Saunders estimates his nursery grows 800 native plant species, many local to the Canberra region. He’s developed a planting system that allows a person to plant 10,000 plants in a day using a two-stroke drill with a planting auger attached. “It’s unbelievably hardcore hard yakka, especially if you’re wading in muck and sewage planting a wetland — or even worse, a mine tailings dam. But if you like hardcore environmental work, this has to be one the best jobs in the world.”

Visit the Seeds and Plants website for more information: seedsandplantsaustralia.com.au

Edited version of Canberra Times article written by Rosslyn Beeby.

Australian Ethical member offer

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 Super member, 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
Employer profile – Digital Eskimo

Digital Eskimo is a strategic design consultancy that has created campaigns and digital solutions for organisations such as ACF, the Powerhouse Museum, University of NSW, University of Technology Sydney and Telstra Digital.

Founder David Gravina, who established the business in 2001, created it with a mission ‘to drive social & environmental progress using the transformational power of collaborative design and technology’.

Digital Eskimo’s considered approach to design is grounded in research, ensuring that design decisions are based on understanding and not assumptions. It’s a human-centred process, based on observing how people do things, what really informs and motivates their decisions, how they use technology and how they interact with the companies and services for whom they are designing.

Digital Eskimo also design with, and not just for, their clients’ communities. Getting end users to be part of the creative process leads to solutions far better suited to their needs and habits than one imagined by a designer working alone at a desk.

The outputs of this design process can be widely varied – websites and online applications, community engagement and social strategies, behavioural change campaigns, learning tools and games.

A recent project is Water Worx, an iPad game (illustrated below) that is part of Sydney’s Powerhouse Museum’s permanent ‘ecologic’ exhibition, about sustainable living. Sydney Water and the Powerhouse Museum wanted to teach kids of all ages about the complex task of managing Sydney’s water system.

The game is a highly engaging (some say addictive) way to show how drinking water is provided for a community. The challenge is for kids to keep up with demand. It’s a way of teaching kids that has them literally coming back for more.

For more information on Digital Eskimo’s work, visit their website: digitaleskimo.net

Digital Eskimo use Australian Ethical as their default super fund for employees.
Speaking for the Voiceless

Australian Ethical is proud to be the principal sponsor for the 2012 Voiceless Writing Prize. The Prize is a new initiative aimed at advancing the public’s understanding of animal sentience, human-animal relationships and the ethical treatment of animals. There have been over 350 entries and the judging panel which includes literary giant J. M. Coetzee, 2003 Nobel Laureate and twice winner of the Man Booker Prize, will make their decision in November.

Animal protection is fast emerging as the next great social justice movement as Australians continue to question the journey their food makes from paddock to plate.

Since launching in 2004, animal protection institute Voiceless has promoted respect and compassion for animals, working to lift the veil of secrecy that surrounds factory farming and the commercial kangaroo industry.

Every year in Australia, more than 500 million emotionally complex, intelligent beings such as pigs and chickens, are effectively locked away in sheds or cages, barely big enough to fit their bodies, and often mutilated without pain relief.

Australia is also home to the largest land-based slaughter of wildlife in the world with almost 90 million kangaroos and wallabies lawfully killed for commercial purposes in the last 20 years through brutal means.

To bring positive change to these issues and raise greater public awareness through the media, Voiceless focuses on building animal law as a discipline at universities and law firms, influencing legislative and corporate reform, and creating a powerful network of animal protection advocates from business, science, law and the arts.

The organisation also offers financial support to those working within the animal protection movement. To date, Voiceless has awarded over $1.2 million through its Grants Program, also awarding Media Prizes for coverage of animal issues and the Voiceless Eureka Prize for Scientific Research that Contributes to Animal Protection. The Voiceless Writing Prize, which is sponsored by Australian Ethical Investment, is encouraging quality literature on animal ethics.

With Australians becoming more concerned about the current treatment of animals produced for food, the movement is making progress. For example, the Tasmanian government has announced an impending ban on sow stalls and battery cages, while major food retailers are stocking more humane products, and demand for free range produce is on the rise as more individuals ask questions about the animal on their plate.

While progress has been made, there is still much work to be done to help the millions of animals suffering from institutionalised cruelty every day.

“Ultimately, each of us must respond to animal cruelty in our own way and the response is often a journey, where the starting point is learning the truth that lies behind your fork,” said Dana Campbell, Voiceless CEO.

Elise Burgess
Senior Communications Officer
Voiceless
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 been 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.

New investments – Alchemia

Alchemia (ACL) is an Australian biotechnology company (ASX listed: ticker ACL). The company’s particular expertise in chemistry has been applied to the discovery and development of human therapeutic products. Its two key business areas are Alchemia Fondarparinux and Alchemia Oncology

A two pronged attack

The company has an on-market generic drug called Fondarparinux, which is primarily used following orthopaedic surgery (such as hip or knee replacements) in order to minimise potentially deadly artery and blood vessel blockages. The drug is currently being manufactured and sold to US pharmacies and hospitals by Alchemia’s Indian generics drug partner Dr. Reddy’s Laboratories (NYSE: RDY).

Alchemia and Dr Reddy’s currently share the profits from Fondarparinux evenly, after the deduction of the costs of manufacturing and selling, general and admin (SGA) costs. However, Alchemia’s share of this profitability is likely to increase as market penetration of Fondarparinux is expanded by Dr Reddy’s more aggressive push in the US and once the therapy is approved and sold into Europe (2013).

The other key business Alchemia Oncology has, is a potentially valuable cancer therapy, HA-irinotecan, in Phase three of development. The therapy in development combines a well-known compound called hyaluronic acid “HA” with a generic chemotherapy treatment called Irinotecan. The theory being the naturally occurring hyaluronic acid will enhance, perhaps at the stem cell level, the activity of the chemotherapy making it more effective. The Phase two study in colorectal cancer (bowel cancer) showed a statistically significant 2.8 month improvement in progression free survival. The clinical results for stage three are due around September 2013.

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)
This chart represents the potential risk and return characteristics of our super options. It is not a forecast of actual risk or returns. The scale is indicative only.

**Defensive option**

**Investment objective**
To provide investors with very low levels of investment risk and preservation of capital through high-grade investments that generate regular income.

**Recommended minimum investment timeframe**
6-12 months

**Asset mix**

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<th>20</th>
<th>40</th>
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<tr>
<td>Defensive 100%</td>
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<td>Growth 0%</td>
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**Returns to 30 June 2012**

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<tr>
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<th>1 year return (%)</th>
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<tr>
<td>Defensive</td>
<td>4.3</td>
<td>4.2</td>
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<tr>
<td>Defensive (Pension)</td>
<td>4.2</td>
<td>4.9</td>
<td>4.6</td>
<td>4.9</td>
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**Conservative option**

**Investment objective**
To receive regular income that is accompanied by low levels of risk to capital and income.

**Recommended minimum investment timeframe**
4+ years

**Asset mix**

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<tr>
<td>Defensive 75%</td>
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<tr>
<td>Growth 25%</td>
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<tr>
<td>Conservative</td>
<td>1.9</td>
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<td>n/a</td>
<td>n/a</td>
<td>3.6</td>
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<tr>
<td>Conservative (Pension)</td>
<td>2.7</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>3.1</td>
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**Balanced option**

**Investment objective**

To provide a balance between the receipt of regular income and capital growth, accompanied by modest levels of risk to capital and income.

**Recommended minimum investment timeframe**

4+ years

**Asset mix**

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<th>Defensive 45%</th>
<th>Growth 55%</th>
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<tr>
<td>Balanced</td>
<td>0.3</td>
<td>2.2</td>
<td>-1.4</td>
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<td>5.1</td>
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<td>Balanced (Pension)</td>
<td>0.9</td>
<td>3.0</td>
<td>-1.4</td>
<td>4.7</td>
<td>5.5</td>
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**Growth option**

**Investment objective**

To provide long-term growth through high levels of investment in growth asset classes, with the remainder in defensive assets including bonds.

**Recommended minimum investment timeframe**

5+ years

**Asset mix**

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<tr>
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<th>Defensive 20%</th>
<th>Growth 80%</th>
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<tbody>
<tr>
<td>Growth</td>
<td>-2.4</td>
<td>0.2</td>
<td>-5.1</td>
<td>4.2</td>
<td>6.3</td>
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<tr>
<td>Growth (Pension)</td>
<td>-2.8</td>
<td>1.1</td>
<td>-5.5</td>
<td>4.6</td>
<td>5.3</td>
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**Smaller Companies option**

**Investment objective**

To provide long-term growth through investment in smaller Australian companies.

**Recommended minimum investment timeframe**

5+ years

**Asset mix**

<table>
<thead>
<tr>
<th></th>
<th>Defensive 5%</th>
<th>Growth 95%</th>
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<th>Since inception (%pa)</th>
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<tbody>
<tr>
<td>Smaller Companies</td>
<td>-4.4</td>
<td>2.7</td>
<td>-1.3</td>
<td>7.0</td>
<td>7.8</td>
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<tr>
<td>Smaller Companies (Pension)</td>
<td>-2.8</td>
<td>4.2</td>
<td>-1.1</td>
<td>7.8</td>
<td>8.0</td>
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</table>
**International Shares option**

**Investment objective**
To provide long-term growth through investment in overseas companies.

**Recommended minimum investment timeframe**
5+ years

**Asset mix**

<table>
<thead>
<tr>
<th>1 year return (%)</th>
<th>3 years return (%pa)</th>
<th>5 years return (%pa)</th>
<th>10 years return (%pa)</th>
<th>Since inception (%pa)</th>
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<tr>
<td>International Shares</td>
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<td>-7.0</td>
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<tr>
<td>International Shares (Pension)</td>
<td>-17.9</td>
<td>-8.0</td>
<td>n/a</td>
<td>-12.5</td>
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**Returns to 30 June 2012**

**Climate Advocacy option**

(not available in Pensions)

**Investment objective**
The Climate Advocacy Fund uses an indexed investment approach intended to deliver returns consistent with the broad Australian share market index, while providing an avenue for active engagement with the companies that are included in that index.

**Recommended minimum investment timeframe**
5+ years

**Asset mix**

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<th>1 year return (%)</th>
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<tbody>
<tr>
<td>Climate Advocacy</td>
<td>-3.7</td>
<td>n/a</td>
<td>n/a</td>
<td>-0.5</td>
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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 or super fund expenses.**

The total returns are based on an investment of $10,000 at the inception of each strategy. Performance figures for each strategy assume an investment in that strategy only.

The total returns are calculated taking into account taxation on super fund earnings and capital gains. Neither the return of capital nor the performance of the super fund 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 1300 134 337.

Interests in the super fund are offered by AEI and issued by the Trustee of the Fund, Australian Ethical Superannuation Pty Ltd ABN 43 079 259 733, RSEL L0001441. The relevant PDS should be read before making an investment decision.
Product news

Fund administration

We use a third party to provide administration services for the Australian Ethical Super Fund. These are services such as processing contributions, making benefit payments and generally managing the administration of the Fund for members.

Every five years, we review the Fund’s administration arrangements to ensure that the services and costs are competitive and represent good value for Fund members. We recently completed this review and received a number of strong proposals from well qualified and reputable service providers. After reviewing these, the Trustee decided to appoint Russell Investments to provide the Fund’s administration services, commencing from around April 2013. Russell already provides superannuation administration services for over 200,000 members and to superannuation funds similar to our Fund. Importantly, Russell runs its own superannuation fund, so they understand the importance of quality service and the need to look after members.

The project to move the Fund’s administration from the current provider to Russell has commenced. Our intention is make sure the transition process runs smoothly and has minimal impact on members. In future communications, we will update you on the progress of the transition and provide you with further information on Russell.

MySuper

You may have heard about the Commonwealth Government’s MySuper initiative (see http://strongersuper.treasury.gov.au).

The Government intends that from 1 July 2013, funds will be able to offer a simple, low cost default superannuation product called MySuper to improve the simplicity, transparency and comparability of default superannuation products.

To be able to offer a MySuper product, superannuation funds will need to be authorised by the Australian Prudential Regulation Authority (‘APRA’). We are reviewing material recently released by APRA for MySuper applications and intend to seek authorisation to offer a MySuper product.

Insurance improvements

An important aspect of the MySuper reforms referred to above is that automatic death & total and permanent disablement insurance will need to be provided to members, on an opt-out basis.

We will in future be providing automatic death and total and permanent disablement insurance, on an opt-out basis through our new group insurer MetLife. In addition, a number of other important improvements are being introduced to our insurance arrangements:

• Transfer in terms – members wishing to rollover to the Fund will (in most circumstances) be able to obtain the same level of insurance cover, with minimal underwriting, as they have outside the fund;

• Members will have the ability to increase their insurance cover upon a life event with minimal underwriting;

• There will be unlimited death cover and higher levels of terminal illness and TPD cover (subject to underwriting);

• An extension of TPD coverage to age 70 (from the current limit of age 65);

• Online insurance capabilities – including the ability to lodge insurance applications online.

More details will be provided as the features are implemented early in 2013.

Smaller Companies Option

The Smaller Companies accumulation and pension investment option will no longer invest in international equities.

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