


# The Leading Edge

QUARTERLY REPORT | **September 2012**

In this edition of *The Leading Edge* we look at how the digital economy is changing the way Australian companies do business and explain how we hope to capitalise on these emerging trends.



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Justin Braitling
Portfolio Manager

We are disheartened with the profit outlook for the larger Australian public companies. With the mining boom rolling over, mining companies are facing leaner years ahead through weaker commodity prices – the major trading banks are also struggling in a soft credit environment and asset performance is deteriorating. Of the remaining industrial sectors, many are battling structural headwinds which we have talked about in previous reports.

With this challenging outlook in mind, capital appreciation will be hard to come by for the market leaders and will instead have to come from elsewhere in our investment universe. We sense some of the better opportunities can be found in the smaller emerging growth companies, many below the radar of the broader investment community.

Outside of healthcare, we have few structural growth sectors to speak of. While the digital economy is transforming our society, sadly we have no meaningful technology sector in our share market as the industry is dominated by offshore players. Outside of technology, digital convergence is having a profound impact on many other sectors however that are benefiting from these trends which we can invest in.

In this edition of The Leading Edge we look at how the digital economy is changing the way Australian companies do business and explain how we hope to capitalise on these emerging trends.

## The digital economy

The tech-bubble that burst spectacularly at the beginning of this century promised a new era of digital technology that was set to change our lives. Advancements in optical networking and an open communications protocol in the Internet allowed for a rapid proliferation of networked devices operating at broadband speeds.

Broadband was made possible by a step change in optical carrier technology in the 1990's – where once data was transmitted over a single optical fibre using a single frequency, multiplexing allowed the use of multiple frequencies across multiple fibres. At the same time the routers and switches that carried the data across these fibres were getting faster as microprocessor speeds improved with Moore's Law (doubling every 18 months).

IP or the internet protocol as an open architecture was a paradigm shift away from the traditional closed proprietary data networks of old. A simple open protocol coupled with broadband speeds has allowed the Internet to become ubiquitous.

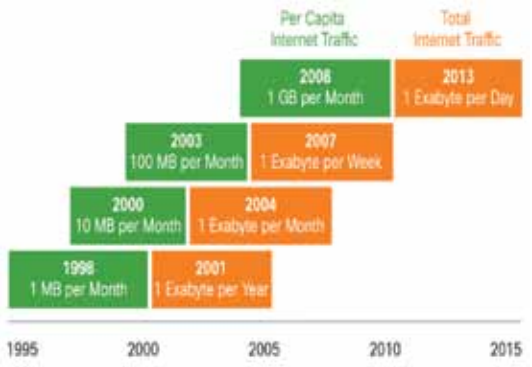
As with any bubble, investor expectations moved well ahead of reality. Early adoption rates were disappointing and the technology did not deliver as expected, particularly in the next generation of wireless networks. If you recall, we were all expected to be video conferencing on mobile devices by now. The exorbitant cost of 3G mobile licenses, disappointing adoption rates and an anti-trust suit against Microsoft were too much for the tech-bulls and the bubble burst.

Bill Gates made some prescient comments at the time suggesting the take up of IP-enabled technologies would disappoint in the short term but exceed expectations in the long term. Fast-forward a decade and while dot-com shares are still well below their lofty heights, the Internet has delivered most of what was promised and has fundamentally transformed the way consumers and businesses interact.

Data traffic has doubled every 1-2 years as forecast, and the number of IP connected devices now exceeds the global population.

MOVING TO ZETTABYTE ERA

FIG 1




Source: Cisco VNI, 2012

In the next few years we will move into what Cisco Systems calls the Zettabyte Era. In 2016, the gigabyte equivalent of all the movies ever made will cross the global Internet every three minutes. The number of devices connected to IP networks will be nearly three times as high as the global population in 2016.

An increasing amount of Internet traffic is originating with non-PC devices. In 2011 only 6% of consumer Internet traffic originated with non-PC devices such as televisions, tablets, smartphones and machine-to-machine (M2M) modules. But by 2016 the non-PC share of consumer Internet traffic will grow to 19% and traffic from wireless devices will exceed traffic from wired devices.

It is the convergent sectors of telecom, media and technology that are benefiting most from the growth in applications and service brought about by the Internet. While we cannot invest directly in this technology in our own share market, we can invest in the infrastructure enabled by this technology, along with the emerging applications and services.

We have significant positions not just in the incumbent Telstra, a clear beneficiary, but also in emerging facilities based competitors such as Amcom, IINet and Next DC. In software, we have invested in SAI Global, and in new media we are a substantial shareholder in Jumbo Interactive and have recently added On The House to the portfolio.

In this quarterly, we review how these new technologies are impacting the convergent sectors of telecom, media and technology outlining how we hope to benefit from investing in companies that are taking advantage of these trends.

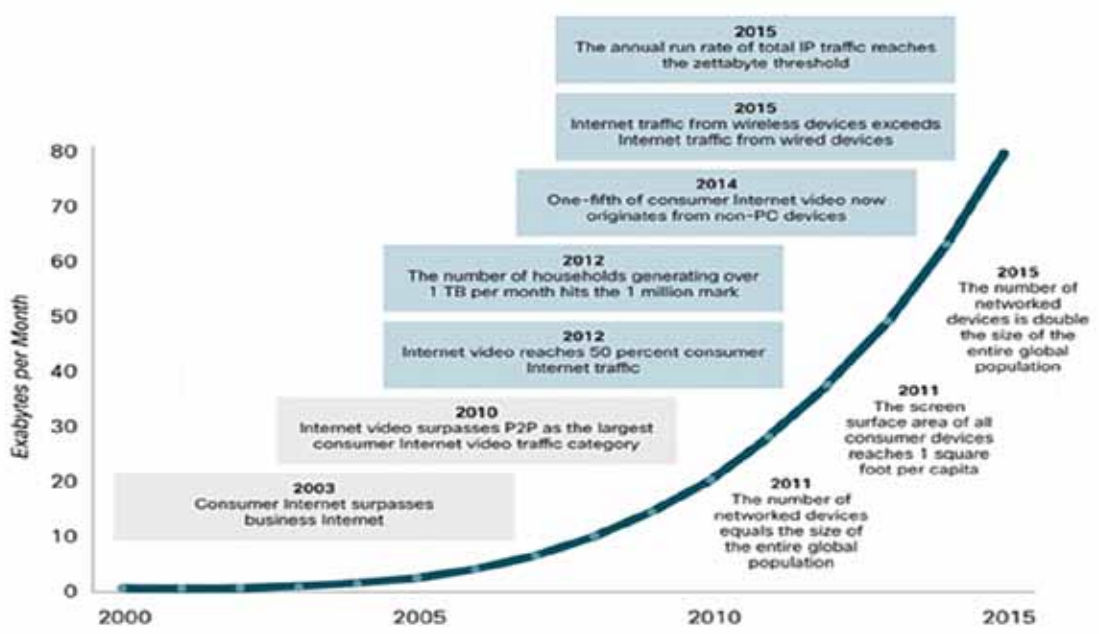
## The telecommunications landscape is rapidly changing

**First the consumer**

Over the past five years, two of the key trends in the telecoms sector have been a sustained shift from fixed to wireless telecom services and an explosion

FIVE TRAFFIC MILESTONES AND THREE TRAFFIC GENERATOR MILESTONES BY 2015

FIG 2




Source: Cisco VNI, 2011

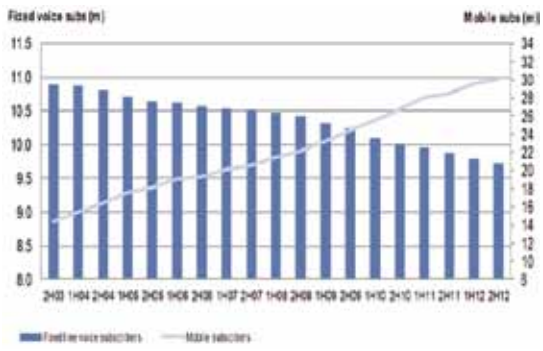
in demand for bandwidth hungry applications and services. These trends have enabled and facilitated Australia's shift to the digital economy. We expect these trends will continue and are likely to accelerate in the future.

**Sustained shift to wireless**

In recent years, one of the key trends driving the telecoms sector has been the sustained and accelerating shift from fixed to wireless telecom services. We believe this has been driven by consumer preference for mobility which has led to innovation in consumer mobile devices (e.g. smartphones, tablets). Recent falls in wireless pricing have only accelerated this move away from fixed line, which in turn has led to increasing investment into wireless networks and continued advancement in technology (e.g 3G, 3.5G, 4G).

Since 2007, we estimate that over one million fixed-line telephony customers have disconnected their phone service. In comparison, the number of mobile subscribers has grown 8% annually to over 30m driving penetration to 135%. In terms of usage, total fixed voice minutes have more than halved, while total mobile voice minutes have tripled over mobile networks, over-taking fixed networks minutes in 2010.

FIXED LINE vs MOBILE SUBSCRIBERS **FIG 3**

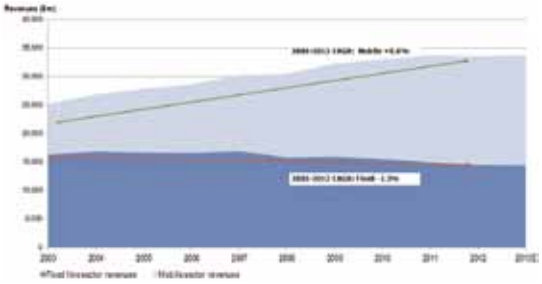



Source: Goldman Sachs Research estimates

The extraordinary growth in wireless broadband has been a surprise. Since the new product category was launched in 2007, the total number of wireless broadband subscribers in Australia has increased to 6.3m, surpassing fixed broadband subscribers of 5.6m for the first time in 2012. Fixed broadband has become mature with household penetration stable at around 65%. In contrast, wireless broadband penetration of the population has skyrocketed from 1% in 2007 to 28% in 2012.

With this shift in customer behavior, mobile has grown from one third of industry revenues at the time of the tech wreck in 2002 to two-thirds by this year.

AUSTRALIAN TELECOMS MARKET - FIXED vs MOBILE REVENUES **FIG 4**



Source: Goldman Sachs Research estimates

We expect these trends to be sustained and to potentially accelerate in the future given the desire for mobility, increasing investment in new technologies such as 4G and continuing innovation in mobile devices.

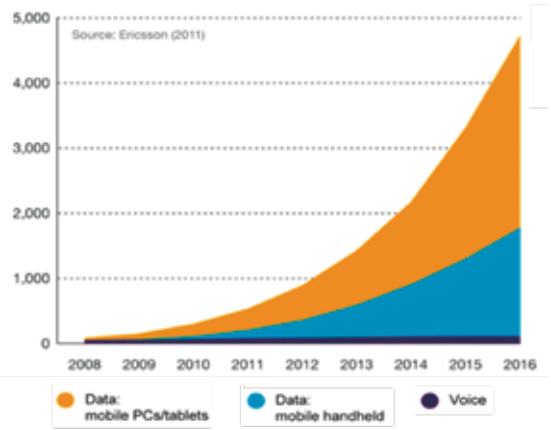
**Data usage will drive mobile revenues higher**

Telecoms manufacturer Ericsson has predicted that mobile broadband data traffic, fuelled by rising demand for internet video content and the next generation of superfast 4G connection services will experience a 10-fold increase by 2016 driving revenue growth for mobile broadband providers.

AUSTRALIA HAS THE SECOND HIGHEST SMART PHONE PENETRATION IN THE WORLD **FIG 5**

EXPLOSIVE GROWTH IN MOBILE DATA

FIG 6




Source: Ericsson

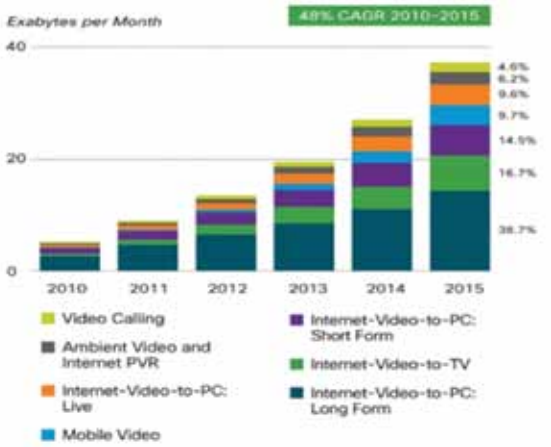
**Growth in bandwidth hungry applications and services**

Over the past 3-4 years, the demand for bandwidth hungry applications has exploded. However, this is likely to pale into insignificance compared with the uptake we will see in coming years.

In our view, the drivers of growing bandwidth demand have been a number of new and innovative applications made possible by faster broadband speeds. A significant growth in peer-to-peer (P2P) applications has allowed large volumes of content and data to be shared online (music, movies, television, gaming, etc). Online video content such as television on demand, Youtube, and Netflix have proliferated and video communication through mobile devices is becoming a reality through applications such as Skype or Cisco web-conferencing.

EXPLOSIVE GROWTH IN INTERNET TRAFFIC

FIG 7




Source: Cisco VNI, 2011

An increasing number of homes now will contain multiple connected devices – a fixed line computer or laptop, a tablet device and one or more smart phones. Lower broadband pricing driven by lower domestic/international capacity pricing has led to increased profit opportunities arising from Australian consumers hungry for content.

As we illustrate in Fig 7, this has driven exponential growth in internet traffic.

In our view, these trends are certain to continue. We expect investment and upgrades to current fixed broadband networks (e.g. NBN) will drive increased speeds and capacity which will accelerate these trends further.

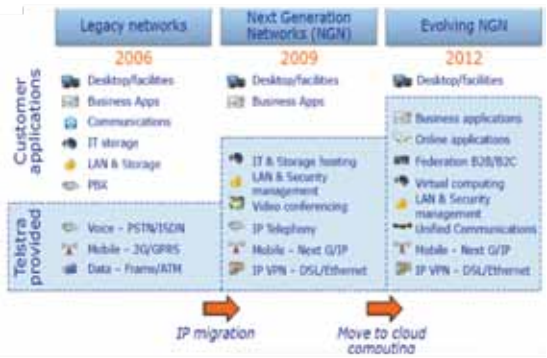
## Digital landscape is rapidly changing for businesses as well

Legacy data networks offered by telecoms to businesses were proprietary systems such as frame relay and ATM developed by the likes of Alcatel and Lucent which were very expensive to set up and manage.

IP has profoundly changed the IT environment for businesses. As IP is an open architecture based on an industry standard, the cost of building these networks is a fraction of legacy proprietary networks, and they are far simpler and cheaper to run. New IP based networks, such as Telstra's Next IP offer businesses a step change in productivity and efficiency. Core products such as IP telephony and IP virtual private networks (VPN) offer better connectivity at a fraction of the cost.

NETWORK EVOLUTION

FIG 8

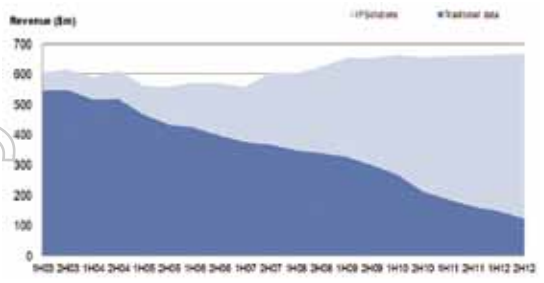



Source: Telstra

For the incumbent Telstra, traditional data revenues have declined 2007-2012 CAGR -18% while revenues from IP Solution have grown 2007-2012 CAGR +20%. The drag from legacy data services is diminishing.

TRADITIONAL DATA vs NEW IP SOLUTIONS

FIG 9




Source: Goldman Sachs Research estimates

Where previously we had telephone networks and proprietary data networks along with a raft of separate business applications and solutions – in a converged IP world all data is carried over the one packet data network employing the one simple standard; IP. This is allowing Telecoms to move up the services stack beyond simple connectivity into applications and managed services, traditionally the domain of IT service companies such as IBM, HP and Accenture.

TELECOM AND IT CONVERGING

FIG 10


**Cloud computing is the next big driver for telecom services:**

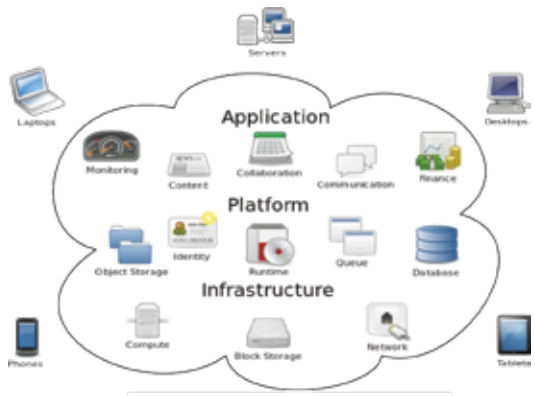
With the advent of low cost computing in the PC, applications were run over Ethernet based local area networks connecting desktops to servers. The step change in network speed and latency brought about by ultra fast broadband (UFB) coupled with the simplicity of IP is changing the client-server model of distributed computing. We are moving into a new era of cloud computing, not dissimilar to where we came from with the mainframe and dump terminals.

As the costs of transporting data and latency have fallen, the model is again shifting where in future all manner of applications and services will be available to rent or purchase remotely over the internet (cloud). The business model of software as a service has users renting applications, software and databases. The cloud providers manage the infrastructure and platforms on which the applications run.

At its essence, cloud computing involves a move from traditional, in-house IT systems to either internal or externally provided flexible infrastructure or services. Rather than designing, building and managing complex computing systems, businesses purchase capacity in an "on demand" model. IT resources can be procured as and when they are needed. Businesses should see a transformation in IT costs and productivity as they require fewer dedicated IT resources.

CLOUD COMPUTING

FIG 11




As more and more applications and services are distributed over IP through the cloud, the demand from telecoms for both network connectivity and managed services will increase significantly. IDC forecasts that revenue from cloud services in Australia will increase from $470m in 2010 to $2.3b by 2015, representing a compound annual growth rate of 34%. According to Gartner, by 2015, 50% of all CIOs expect to operate the majority of their applications/infrastructure via the Cloud.

GLOBAL CLOUD TRAFIC GROWTH

FIG 12


Cisco Systems

Telecom Service Providers are investing heavily to support these new services. For example, Telstra has invested $3bn in its national Next IP network and Next G network to support new services. A further $800m has been committed to support the growing demand for cloud computing services.

## How we plan to profit from the digital economy

First of all, we have invested in the infrastructure providers enabling the digital economy. Telstra as the incumbent with its ubiquitous network coverage is a clear beneficiary. Alternate network providers such as iiNet will do well also particularly as the NBN is rolled out creating a level playing field. Amcom, a facilities based competitor is offering data services to business customers in the west and Next DC will be the only truly national data center provider once the build-out is complete.

## Long Telstra, Short Telecom NZ

Bearing in mind the above thematics, we continue to prefer Telstra over Telecom New Zealand for the following reasons:

**Telstra is the dominant player in Australia, well placed to capitalise on the continued shift to wireless**

Since 2010, when CEO David Thodey embarked on its customer acquisition strategy, Telstra has increased subscriber share from 40% to 46%, revenue share from 41% to 46% and profit share from 55% to 60%.

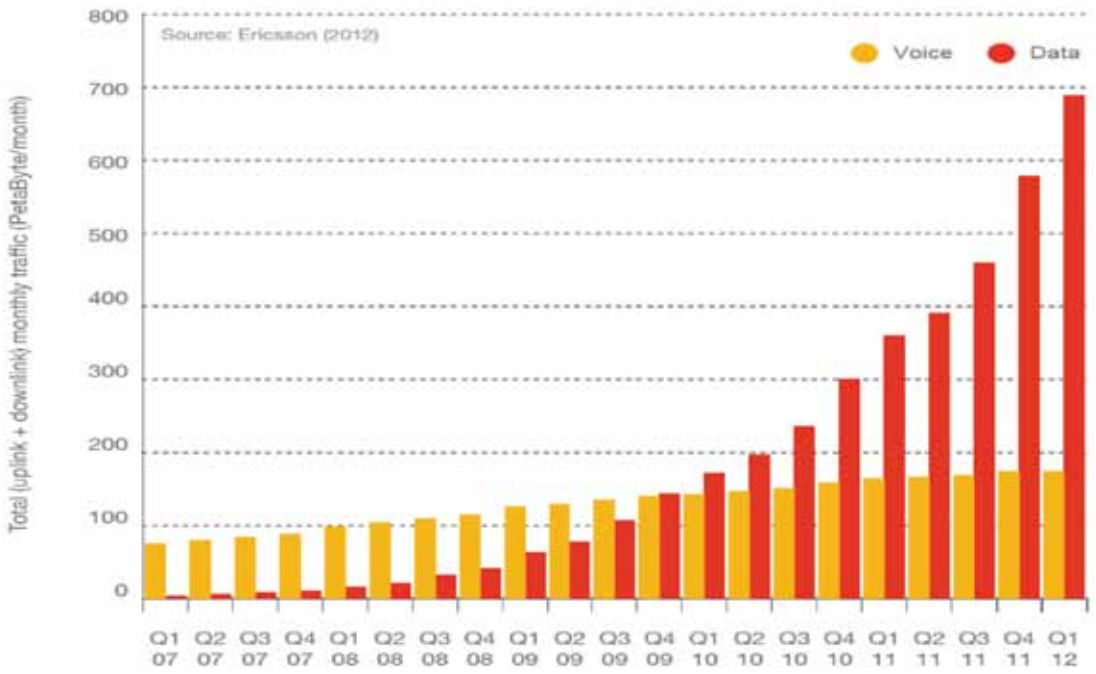
It has been able to achieve this dominance primarily as a result of its mobile network competitive advantage with greater coverage, reliability and capacity. This advantage is driven by a greater number of base stations, technological superiority (e.g. 4G) and fibre backhaul.

In a 2G voice world some of the most successful operators produced results by running light network models with innovative marketing. Exponential growth in data traffic has placed considerable strain on network reliability and these business models have been shown wanting. While Telstra may not have been the most innovative company they always had network superiority, increasing demands on network are playing to Telstra's strengths.

Strategically Telstra is wise to continue to invest heavily in its network. The company will spend $1.2bn this year, a record in spite of their clear leadership to sustain this advantage as they extend their 4G coverage from 40% to 66% by June 2013.

NETWORK PERFORMANCE IS KEY GIVEN DATA GROWTH

FIG 13

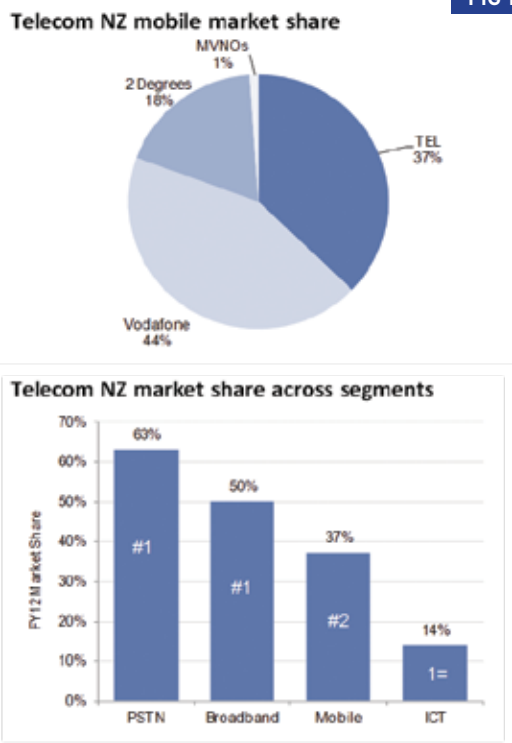



Source: Ericsson

**Telecom NZ is a weaker #2 player in New Zealand behind Vodafone**

In contrast, despite being the incumbent, Telecom NZ is the #2 mobile operator in New Zealand behind Vodafone. They made a number of poor technology choices (e.g. CDMA technology) over the past 10 years which has cost them dearly.

FIG 14




Source: Goldman Sachs Research estimates

**Telecom NZ's mobile business faces a number of challenges**

Vodafone has recently invested NZ$840m acquiring TelstraClear, New Zealand's #2 fixed line operator from Telstra. In our view, not only does this deliver Vodafone fixed line scale and the ability to bundle, it also delivers fixed line infrastructure (e.g. fibre, backhaul) that will greatly improve the cost structure of Vodafone's mobiles business. We believe with TelstraClear, Vodafone will be a more formidable competitor.

**New Zealand is 2-3 years behind Australia in the shift to wireless**

Telecom NZ has a much higher proportion of legacy fixed revenues at risk. The New Zealand market is probably 2-3 years behind Australia in terms of the shift to wireless services. Consider the following:

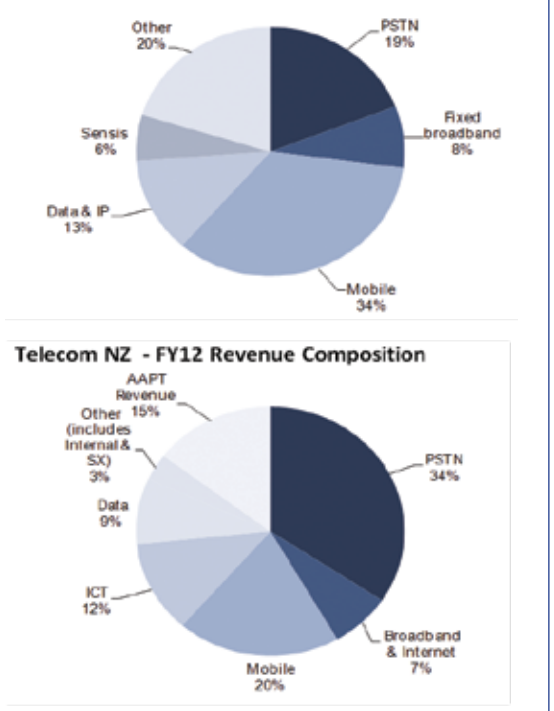
*Revenue composition*

As of FY12, the traditional Public Switched Telephone Network (PSTN) accounting for 19% of Telstra's total revenues compared with Telecom NZ at 34%. Mobile revenues comprised 34% of Telstra's total revenues compared with 20% for Telecom NZ.

The shift to wireless in NZ will most likely accelerate given the trends evident in Australia and globally. We believe Telstra is relatively better placed to capitalise on the shift to wireless for the following reasons. Firstly, its network dominance in the market and secondly, Telecom NZ is only the #2 mobile operator and facing a far more formidable #1 competitor in Vodafone following the TelstraClear acquisition.

Telecom NZ also has a far higher proportion of traditional fixed line revenues to lose. While PSTN revenues continue to be a significant drag to Telstra, the drag is likely to last a lot longer for Telecom NZ.

FIG 15




Source: Goldman Sachs Research estimates

While Telstra is well positioned to benefit from the digital economy, the shares have been very strong in 2012 and are approaching fair value. There are risks also with a change of government and the prospect of further changes to the regulatory environment which we need to be mindful of. In particular Telstra receives close to $500 million in cash payments from the

National Broadband Network (NBN) which could be threatened by a coalition government. For this reason we have sold (short) Telecom NZ which has also performed well as a hedge against our investment in Telstra for the reasons outlined above.

## iiNet (IIN)

**Investment Case**

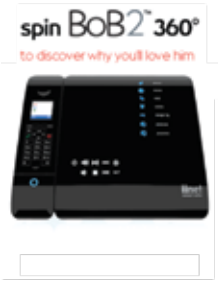
iiNet serves over 1.3 million broadband, telephony and Internet Protocol TV (IPTV) customers, and is Australia's 3rd largest Internet Service Provider. The company continues to distinguish itself in a noisy telecoms marketplace through excellent customer service, again winning the Customer Service Institute of Australia Award in 2011.

IIN is set to deliver strong earnings growth over the next few years. Firstly by extracting cost synergies from recent ISP acquisitions (Internode, AAPT, TransACT) which to date have exceeded expectations. Secondly, from an improving regulatory environment via cheaper wholesale pricing which will lower the cost of line rental and support margins. On the customer front, management are focused on improving product penetration and driving deeper into the small business segment with the late 2011 acquisition of TransACT.

In our view iiNet provides an invaluable competitive advantage due to its strong brand (developed through superior customer service). This type of edge takes years to build and is the result of CEO Michael Malone's direct stewardship. IIN has also differentiated its offering through a number of innovative and first to market pricing and product initiatives, for example BoB (Fig. 16).

iiNet PRODUCT INNOVATION

FIG 16




- **Available to rent for just 9.95 per month.**
- Brings superfast iiNet broadband to your home
- Rock solid wireless performance
- Answering machine for all your missed (or screened) calls
- USB charge ports (for your mp3 player and mobile)
- Ready for fetchtv.
- Sleek, modern design (he can even go on the wall)

Source: iiNet

The NBN will be a game-changer for the industry as it facilitates increased competition, particularly in regional Australia. We believe IIN is well placed as it will become more competitive in regional areas following Telstra's structural separation, leveling the playing field. We believe IIN's strong brand will give it a unique edge to compete in an NBN world.

## Amcom (AMM)

In telecom, alternate carriers come in many shapes and sizes. Simplistically, they can be separated into facilities based competitors or straight resellers. While the reseller model has low barriers to entry and is vulnerable to predatory pricing, local facilities based competitors like Amcom have significant barriers to entry and tend to operate with far less competition.

The platform is very simple, they build concentric fibre rings in regional centers and connect as many buildings as they can to their backbone. Then it is a matter of selling data connections to as many clients as possible in each of buildings connected to their network.

In addition to either lit or dark fibre connections for business clients, they also offer a full complement of data and communications solutions: unified messaging, VPN's and wide area networks connecting multiple offices and/or offsite storage.

These models have been around for a long time. They are more exciting now though given the growing data needs of businesses and the more affordable cost of fibre based solutions. Even small businesses with 10 or more employees can afford a simple 10GB Ethernet solution over fibre.

*Investment Case*

Amcom is an IT and Telecommunications company providing a national data network with a product range spanning corporate data and internet services, unified communications and IP voice, managed services and cloud solutions. This product range is supported by 2,200km of high speed fibre-optic networks in Perth, Adelaide, Darwin and Alice Springs.

FIG 17


Source: Amcom

Amcom is benefiting from the increasing demand for data services and data transmission as businesses are looking for reliable high-bandwidth solutions at affordable prices.

Not many ASX listed companies can boast profit growth of 20%+ year in year out for a decade. Amcom has a unique position in the West alongside Telstra with fibre up the rises in approximately 1000 buildings connected to its backbone network. Their focus is on in-building penetration selling straight-forward fibre-based Ethernet services.

Following years of success selling basic connectivity to small and medium sized business in the West, they are now moving into managed services and cloud solutions to complement their core fibre revenues. To help them in this cause they acquired L7 in 2011, a Perth based IT consultant with strong ties to Cisco.

We would expect Amcom to delivery strong profit growth for years to come as they continue to add customers and services to their network.

## NextDC (NXT)

*Investment Case*

NXT is rolling out Australia's only truly national data centre network, providing highly efficient space for businesses shifting their IT infrastructure externally. Gone are the days when a business could get by with a server or two run out of the broom closet. As wide area network connectivity has become a business critical function, IT infrastructure has become more complex and energy intensive making external data centres an attractive choice with improved availability, reliability, connectivity and cost.

Bevan Slattery founded NextDC with the vision of creating Australia's only independent "carrier agnostic" data centre network. Bevan has a fantastic track record of shaping industry and creating shareholder value, having built PIPE Networks from scratch before selling it to TPG Telecom for $373m.

While most data centres are run by managed service providers like IBM and HP, who manage and operate your infrastructure, or by telecoms who want to sell connectivity, NXT aims to be the only independent or "carrier agnostic" data centre provider in Australia. They simply offer the space in a purpose built, state of the art collocation centres – not dissimilar to what a Westfield offers specialty retailers. This is no ordinary space however, the ultramodern facilities are far more energy-efficient and scalable, offering superior economics over the legacy centers – most of which are over-flowing.

NXT has so far commissioned data centres in Brisbane, Canberra and Melbourne, with Sydney and Perth expected to come on-stream in the following 12 months. Each site offers cutting edge Power Utilisation Efficiency (PUE), which is the key cost in accessing a data centre.

FIG 18

NATIONAL CAPABILITY

Delivering Australia's first national network of independent data centres for our customers

| Facility | B1 Brisbane | M1 Melbourne | C1 Canberra | S1 Sydney | P1 Perth |
|---|---|---|---|---|---|
| Location | Brisbane CBD | Port Melbourne | Bruce | Macquarie Park | Malaga |
| Facility Size | 3,000m² | 17,500m² | 6,000m² | 17,850m² | 10,500m² |
| Technical Space | 1,000m² | 6,000m² | 2,000m² | 5,600m² | 3,000m² |
| Capacity | 5 MVA | 22.5 MVA | 6.0 MVA | 20.0 MVA | 14.0 MVA |
| IT Load | 2.25 MW | 12.0 MW | 4.0 MW | 11.0 MW | 6.0 MW |
| Target PUE | 1.6 | 1.4 | 1.4 | 1.3 | 1.3 |
| Operational | Now | Now | Now | Q3 2013 CY* | Q4 2013 CY* |

NXT aims to have most of the key telecoms, ISP and service providers operating in their data centres to create an "ecosystem" facilitating low cost data exchange with minimum latency. A key advantage of the Ecosystem is a customer's freedom to deal with alternative providers without the heavy financial burden usually associated with switching service providers. A client located in a NextDC data centre using Telstra for example can easily switch to Optus without having to uproot its servers and physically move.

As the market's appetite for energy-efficient hosting increases, we anticipate NXT's assets will be highly prized by global data exchange operators such as Equinix and Global Switch looking for regional footprints like that held by NextDC.

## ONTHEHOUSE HOLDINGS (OTH)

In addition to the infrastructure making the digital economy possible, we are also investing in digital media offering a raft of new content and applications across the digital spectrum.

Onthehouse is fast becoming the leading online real estate content provider in Australia. The company is based on two key platforms offering dual revenue streams. The real estate software business receives annuity style revenue, whilst the consumer online division is on the cusp of monetisation. The company has struggled to attract investors after a disappointing float last year, however we believe the business can build upon its solid foundations through a unique positioning in the market.

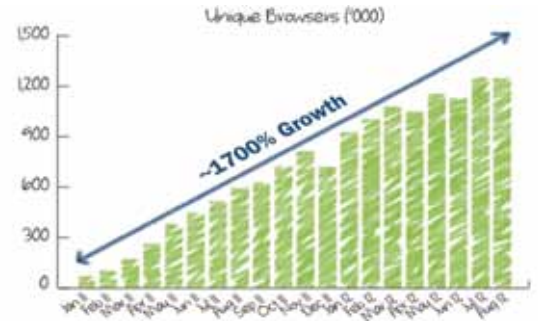
The company was founded in 2006 after its owners identified the difficulties consumers face in accessing comprehensive real estate information. This insight spawned onthehouse.com.au, offering potential buyers and sellers access to a broad array of real estate content including sale listings, historical sale prices and property value analysis. The company then embarked on a number of strategic acquisitions to develop the property analysis section of its database.

The real estate services division is the result of two acquisitions – Console and PortPlus, which together provide the necessary software for more than 40% of Australian real estate agencies. Onthehouse offers a bundled product to agencies, encompassing all their back and front office software needs — of which they are currently the sole market offering. While this business provides a growing annuity revenue stream, more importantly it holds real-time data on a large number of Australian properties able to be fed to the consumer business.

The consumer online business model follows in the footprints of successful offshore companies Zillow and Zoopla. It is built around providing timely and quality real estate data free to consumers, driving large traffic volumes which can then be monetised. Despite almost zero marketing, the website's viewership has grown exponentially over the last two years — over 1700% growth since January 2011. With such a targeted audience base, demand from advertisers will be high. The future challenge will be to expand the database while creating a customer-friendly user experience with reliable and distinctive information to stand above the competition.

TRAFFIC GROWTH – ONTHEHOUSE.COM.AU

FIG 19




Source: Onthehouse.com.au

We are attracted to the stable profits of the software business and will closely monitor the success of the new bundled offering. However the blue sky opportunity is for stellar growth through the consumer online business. Online usage figures are growing and monetising this niche audience will be the key to growing profits.

ONTHEHOUSE

FIG 20


## JUMBO INTERACTIVE (JIN)

Jumbo Interactive is an online wholesaler and retailer of lottery games predominantly through its hugely successful website ozlotteries.com. Revenue has climbed four-fold in the last five years from $25m to $100m annually as product innovation and consumer preferences have driven demand for online lottery sales. As with many digital businesses, Jumbo has reached a tipping point, with profits accelerating. We believe this will continue, and the business can grow for many years as the digital economy in Australia takes off.

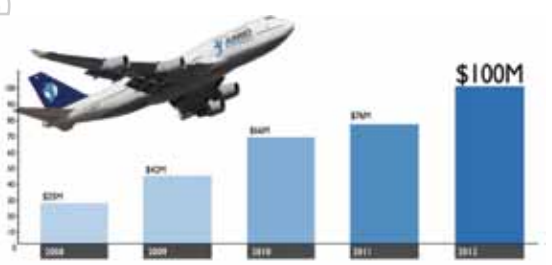
The company was founded in 1999 by current CEO and major shareholder Mike Veverka. At the time, Jumbo developed e-commerce software for a number of industries with modest success. The business sold its first online state lottery ticket in 2000 and moved nationally with the acquisition of TMS Global in 2005. Jumbo continued to foray into non-lottery e-commerce until late 2010, when the business was streamlined to focus solely on online lottery sales.

The significant sales growth has been driven by two key factors. Firstly, consumers are increasingly purchasing online. This preference is accelerating with the penetration of mobile devices, as a pure online retailer Jumbo is benefitting from this momentum. Secondly, Jumbo has unique product innovation

driven through ten years of development. The company offers lottery players a choice of options such as syndicate play through Facebook, emailed results and retailer participation.

LOTTERY REVENUE

FIG 21



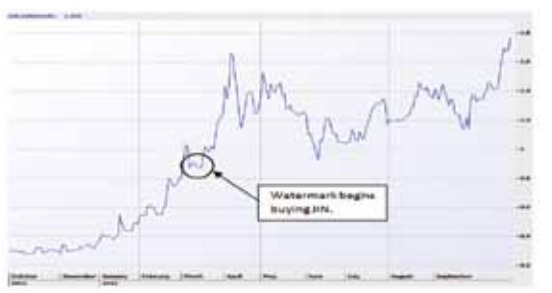

As Jumbo are not lottery operators, they rely upon distribution agreements with the industry bodies. In Australia, Jumbo holds agreements with Tatts in NSW, Vic and NT, as well as the South Australian Government. There always exists the risk that these agreements will not be renewed, however we view this as unlikely considering some of the recent agreements established with Jumbo.

Despite the significant upward growth the company is seeing in Australia, there exists an even larger opportunity in the US. In December 2011, the US Department of Justice declared the Wire Act not applicable to lotteries, opening up a $56bn lottery market which currently has zero sales online. Jumbo has been actively marketing in the US for the last three years and hope to sign an agreement similar to that of Australia.

Jumbo is clearly a company benefitting from the digital economy, with only 7% of Australian lottery tickets currently sold online, we see penetration growth continuing for years to come. We believe the market is not factoring any success in international markets either, offering considerable upside if they are successful on this front.

JUMBO INTERACTIVE

FIG 22



## Market Outlook

The rally in equity markets that commenced back in June has been underpinned by unprecedented monetary stimulus from central banks in advanced economies. With the European Central Bank, US Federal Reserve, Bank of Japan and Bank of England all engaging in large scale asset purchases or "quantitative easing", the prospect of a disorderly resolution to Europe's sovereign debt crisis or of the US economy slipping back into recession is diminished. While equity markets have diligently marched higher to the central bankers tune, the economic fundamentals have weakened further as the European recession deepens and the US recovery stalls. Growth in emerging markets is also slowing along with trading activity with the West.

The bulls and bears are having one almighty wrestle at the moment with the bulls clearly winning the day. They would have you believe the US economy, though weak, is showing signs of resilience and the European economy will recover as strains in financial markets ease. China and emerging markets have avoided a hard landing and activity is set to re-accelerate later in the year. The bears on the other hand point to a deepening recession in Europe as front-loaded austerity and a credit crunch start to bite, a US economy growing at just 1-2% approaching a "fiscal cliff" next year and a hard landing in China.

We are firmly in the realist camp, expecting weaker growth in advanced countries to continue into 2013. While we expect to see a modest pick-up in China in the short term, this may be short lived as the investment lead growth model looks unsustainable.

Either way corporate profits are under pressure everywhere. The latest quarterly earnings reports out of the US were poor and the outlook commentary was even worse, as sales from international operations softened and record margins came under pressure. While analysts are looking for a resumption of profit growth in the medium term, having fallen modestly in the latest quarter, we suspect profit growth will be more anemic in 2013.

With this back drop in mind, it is difficult to foresee a scenario where equities move materially higher in the absence of any meaningful resumption in profit growth. As profit expectations have fallen while shares have moved sharply higher, equity markets have been re-rated relative to underlying profits and now look more fully valued.

Elevated risks associated with debt sustainability in advanced countries and imbalances in emerging markets will be with us for some time. While the focus has been on Europe through most of 2012, I suspect the spotlight

will shift across the Atlantic next year as a divided US Congress battles to deal with the pending fiscal cliff, the federal debt ceiling and a medium term fiscal consolidation plan.

The Australian share market has also moved sharply higher in the September quarter with industrial shares leading the way having risen 20% in the last year. Again, this has happened against a backdrop of lower profit forecasts leading to a re-rating of our market (p/e expansion). If the market is to hold recent gains, profit growth both here abroad has to resume, and on that note we are less sanguine.

The interplay between two opposing economic forces on the Australian economy has left economists divided on the outlook for growth in the medium term. The economy is facing a sizable income shock from falling commodity prices, made worse by a runoff in mining investment next year. The optimists look to an easing in financial conditions from lower interest rates and a weaker Australian dollar to boost private sector activity which has been weak in non resource states. We are more circumspect however, having witnessed how unresponsive US households have become to zero bound interest rates in a deleveraging cycle. The key indicator to watch is confidence. If confidence improves activity will pick up and the bulls will be vindicated. It is also worth keeping an eye on inflation as it has jumped up recently and may encumber the Reserve Bank's hand in easing rates further.

So in summary, profit growth in advanced economies is very soft and unlikely to improve any time soon. Equity markets have moved higher as the acute phase of the European crisis seems to have passed and shares are now looking more fully valued, particularly given the low return environment we find ourselves in.

On this basis, we are maintaining our conservative portfolio settings with low equity market exposure. While we are still very comfortable with our forecasts for low growth, we have increased our market exposure modestly in October, recognising the reduced prospect of a disorderly resolution in Europe.

## Performance

We were particularly pleased with the fund's performance in the September quarter with a gross performance of 8.5%, modestly ahead of the market at 8.2%. While at first glance this does not appear like such a strong result, given we had almost all of our shareholder's funds in cash and hybrids with negligible market risk, this should be seen as a very strong result. We cannot expect to match this level of performance going forward if shares continue to rally as they have in last quarter.

## ALF Funds Snapshot

| Fund Statistics | |
|---|---|
| Fund NAV AUD (Millions) | $91.6 |
| Long (69) | 148.8% |
| Short (56) | -142.3% |
| Gross Exposure | 291.0% |
| Net Exposure | 6.5% |
| Cash | 93.5% |

| Top 10 Holdings | | | |
|---|---|---|---|
| Telstra Corp. Ltd. | 8.2% | Origin Energy Ltd. | 4.7% |
| Rio Tinto Ltd. | 6.0% | Crown Ltd. | 3.8% |
| National Australia Bank Ltd. | 5.6% | Commonwealth Bank of Australia | 3.7% |
| JB Hi-Fi Ltd. | 5.3% | Orica Ltd. | 3.6% |
| Transurban Group | 5.2% | Jumbo Interactive Ltd. | 3.6% |

## ALF Portfolio Returns to September 2012

| ALF | 1 MONTH | 3 MONTHS | 1 YEAR | 3 YEARS (P.A.) | 5 YEARS (P.A.) | SI (P.A.) |
|---|---|---|---|---|---|---|
| Long | 2.7% | 10.4% | 22.4% | 6.7% | 6.5% | - |
| Short | 3.0% | 5.8% | 3.5% | -0.9% | -5.3% | - |
| Gross | 0.1% | 8.5% | 32.0% | 9.1% | 12.3% | 17.4% |
| Net | 0.3% | 7.8% | 28.7% | 5.9% | 8.0% | 14.0% |
| Index | 2.1% | 8.2% | 13.4% | 1.8% | -3.6% | 7.9% |
| Net Alpha | -1.9% | -0.4% | 15.3% | 4.1% | 11.6% | 6.0% |

## ALF Monthly Net Returns

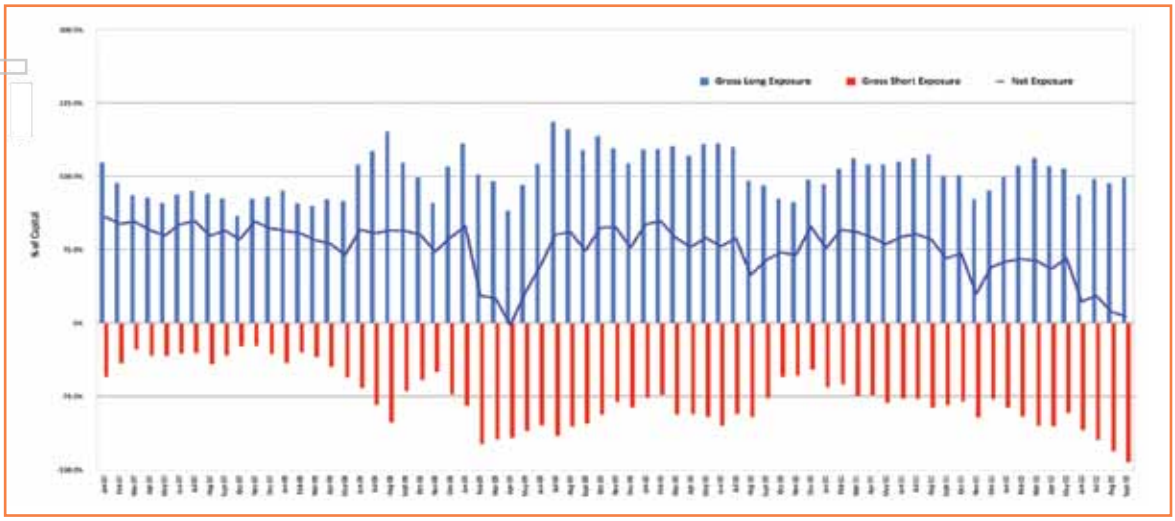
| FY | Jul | Aug | Sep | Oct | Nov | Dec | Jan | Feb | Mar | Apr | May | Jun | ALF FY | INDEX |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2004 | - | - | - | - | - | - | - | 0.4% | 1.4% | 0.2% | -0.0% | 2.3% | 4.3% | 9.0% |
| 2005 | 1.1% | -0.3% | 4.6% | 2.8% | 4.4% | 2.4% | 0.3% | 1.3% | -0.9% | -6.1% | -0.4% | 4.8% | 14.3% | 24.7% |
| 2006 | 2.0% | 2.7% | 4.8% | -3.0% | 3.9% | 3.7% | 1.5% | 2.0% | 6.4% | 2.9% | -2.1% | 1.4% | 29.0% | 24.2% |
| 2007 | -3.2% | 4.3% | 1.7% | 7.2% | 2.8% | 2.5% | 3.1% | -1.6% | 3.5% | 1.1% | 2.7% | 2.0% | 29.2% | 30.3% |
| 2008 | -1.0% | 3.4% | 3.3% | 1.0% | -0.3% | -1.9% | -11.5% | -8.4% | 1.4% | 4.4% | 1.5% | -7.2% | -15.5% | -12.1% |
| 2009 | -1.3% | 5.1% | -5.4% | -16.3% | -6.6% | 3.0% | 2.2% | 2.9% | 16.0% | 6.7% | 7.9% | 7.0% | 18.7% | -22.1% |
| 2010 | 9.2% | 12.4% | 6.5% | -0.7% | 0.8% | 0.1% | -3.5% | 2.2% | 4.2% | -2.1% | -7.1% | -2.3% | 19.9% | 13.8% |
| 2011 | 2.8% | -3.9% | 2.3% | 0.0% | 2.7% | 12.0% | 2.0% | 1.9% | 3.6% | 1.7% | -1.8% | -1.8% | 22.9% | 12.2% |
| 2012 | -4.1% | -6.8% | -8.4% | 6.5% | -1.5% | 0.9% | 4.9% | 4.7% | 3.3% | 1.2% | -2.4% | 0.7% | -2.3% | -7.0% |
| 2013 | 3.7% | 3.6% | 0.3% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 7.8% | 8.2% |

## ALF Portfolio Exposure as of September 2012

| Sector Exposure | LONG | SHORT | NET | INDEX | ACTIVE |
|---|---|---|---|---|---|
| Consumer Discretionary | 24.3% | -22.4% | 1.9% | 5.0% | -3.1% |
| Consumer Staples | 2.2% | -7.8% | -5.6% | 8.1% | -13.7% |
| Energy | 14.7% | -17.4% | -2.7% | 7.8% | -10.5% |
| Banks | 13.8% | -2.5% | 11.3% | 24.7% | -13.3% |
| Real Estate | 7.0% | -3.7% | 3.3% | 7.5% | -4.1% |
| Other Financials | 7.7% | -11.0% | -3.2% | 6.6% | -9.8% |
| Health Care | 7.9% | -23.0% | -15.1% | 4.2% | -19.2% |
| Industrials | 24.2% | -23.0% | 1.2% | 7.6% | -6.4% |
| Materials | 28.7% | -20.9% | 7.8% | 21.2% | -13.5% |
| Utilities & Telecos | 18.1% | -10.5% | 7.6% | 7.4% | 0.2% |
| **TOTAL** | **148.7%** | **-142.3%** | **6.5%** | **100.0%** | **-93.5%** |

| Market Cap | LONG | SHORT | NET | INDEX | ACTIVE |
|---|---|---|---|---|---|
| ASX Top 100 | 93.0% | -53.5% | 39.5% | 85.9% | -46.3% |
| 100 - 200 | 16.6% | -76.9% | -60.3% | 7.2% | -67.5% |
| Ex 200 | 39.2% | -11.9% | 27.3% | 6.9% | 20.4% |
| **TOTAL** | **148.7%** | **-142.3%** | **6.5%** | **100.0%** | **-93.5%** |

## ALF Historic Exposure



## Notes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