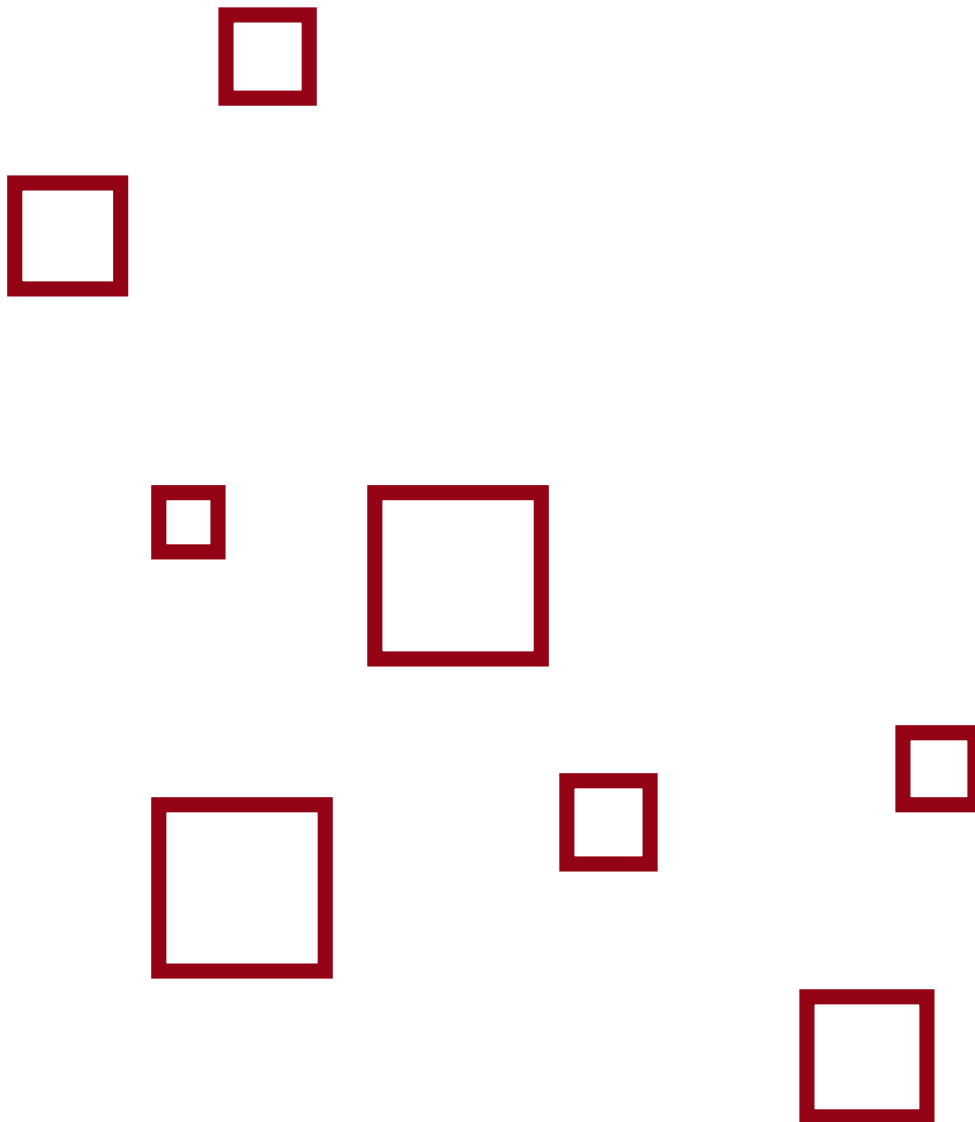


# Perpetual's Wholesale International Share Fund

July 2010



## Introduction

The Perpetual Wholesale International Share Fund is managed by PI Investment Management Limited (PI), a wholly owned subsidiary of Perpetual Limited.

The portfolio objective is to outperform the market index by 3% per annum over a 3-5 year period, with due regard to downside risk.

## Performance summary

In relative terms, the portfolio underperformed the MSCI World Ex Australia Index by 0.1% over the quarter. The portfolio has out-performed the index by 3.4% and 2.3% per annum over two and three years respectively.

## Market Summary

The MSCI World ex-Australia index finished the quarter 4.8% lower, with consumer staples, consumer discretionary and telecom services the best performing sectors, while energy, materials and financials lagged the market. Financials were in the spotlight as SEC sued Goldman Sachs for allegedly misstating and omitting facts about collateralised debt obligations. In the US, the Federal Reserve lowered its assessment of the economic recovery and there was a 16.4% fall in consumer confidence in June. Fears that the global outlook will lead to a deflationary trend drove investors into safe haven treasuries. US bonds rallied in June with the ten-year yield finishing the month at 2.93%, its first time hitting these levels in 14 months. The yield spread between the Greek and German ten-year bond has increased significantly during the second quarter, rising from 344 to 784 basis points as Moody's Investor Services downgraded Greece government bond ratings to junk status. Spain's current Aaa rating was placed on review for a possible downgrade by Moody's as the country faces challenges in meeting fiscal targets. Commodity prices fell in response to the heightened economic uncertainty. Oil has fallen 16.5% from its recent high of \$88.45/bbl on May 3rd as concerns remained over a possible slowdown in economic growth in the US and China and the ongoing debt crisis in Europe.

## Portfolio characteristics

### As at 30 June 2010

The portfolio is close to fully-invested, with only a small exposure to cash.

	Portfolio (%)	Index (%)
Equity	99.2	100.0
Cash	0.8	0.0
Total	100.0	100.0

During the quarter the portfolio held between 63 and 65 stocks (65 at quarter-end).

	Portfolio	Index
No. of stocks	65	1566

Top 10 Holdings	Weight (%)
Nestle	4.50
Johnson & Johnson	3.90
Novartis	3.50
Wal-Mart	3.50
Philip Morris International	3.40
Total SA	3.00
Hewlett-Packard	2.50
General Dynamics	2.30
Emerson Electric	2.20
Automatic Data Processing	2.10

	Portfolio	Index
Price/Earnings Ratio (P/E)	11.9	12.4
Dividend Yield	3.4	2.9
Return on Equity (ROE)	19.9	14.8
Debt / Equity Ratio	32.0	54.0

Period ended 30 June 2010	1 month	3 month	6 months	1 year	2 years p.a	3 years p.a	5 years p.a
Portfolio return (AUD) (before fees and tax)	-3.00	-4.92	-3.80	4.76	-2.69	-9.14	-1.03
MSCI World ex Australia Accumulation Index (AUD)	-4.15	-4.81	-3.75	5.22	-6.13	-11.46	-2.16
Relative Performance	1.15	-0.10	-0.05	-0.45	3.44	2.33	1.13

Source: RBC Dexia / Datastream

\* Note: This investment strategy began 31 March 2005. 2 year, 3 year and 5 year figures are annualised.

## Performance analysis

### Top Performers – Contribution by Stocks Held

Top 10 Contributing Stocks	Contribution
Nestle	0.32%
Daito Trust Construction	0.31%
Republic Services	0.25%
M & T Bank Corp	0.21%
Fresenius Medical Care AG	0.18%
Keyence Corp	0.18%
Shimamura Co	0.13%
Johnson & Johnson	0.12%
Altria Group	0.11%
Novartis	0.10%

**Nestle** has delivered organic sales growth of +5% or above in 17 of the last 21 years. In addition, its margins remained flat in just three of the last 14 years, while increasing by an average of 30bps in the other 11 years. The company recently announced a target to lift sales from Emerging Markets to 45% of total sales by 2020 (35% in 2010). In absolute terms, Nestle already has a substantial emerging market exposure at CHF35bn and its presence is accelerating and broadening with ten countries already generating annual sales in excess of CHF1bn. Brands are key to Nestle's success with 28 "billionaire brands" (<CHF1bn in sales), such as Nespresso, Pure Life, Maggi, Purina and Coffee-Mate, in various categories within Nestle's portfolio. Many of these brands continued to deliver strong growth, even in the more difficult consumer environment of 2009. In FY 2009, Nespresso grew over +20%, Pure Life, Coffee-Mate and Beneful all grew into double-digits and Purina grew in the high single-digits. Nestle is commencing a new CHF10bn buyback programme using proceeds from the completion of its stake in Alcon.

**Daito Trust** operates building construction and real estate businesses in Japan. Japanese landowners have been significantly incentivised through tax breaks to develop residential construction as an alternative to leaving land unutilised. Daito's method of visiting landowners directly and tapping into potential demand has a higher rate of success than conventional sales activities involving introductory recommendations. As a result, 70–80% of orders are derived from this direct approach. Following the recent periods of deflation and economic stagnation in Japan, there are an increasing number of people who are choosing not to buy their own homes to avoid burdening themselves with large amounts of debt and are instead opting for home renting that allows freedom to move house. With expectations for a rise in the utilisation of rental housing, owing to the growth of senior households and an increasing trend in rental housing rates for young family units, future prospects for steady demand are good. Daito Trust has been debt-free since its establishment and

boasts a very strong balance sheet. As of end-March 2010 it had 20% of its market cap in cash. The stock trades on a P/E of 11.9x, dividend yield of 4.1%, (a total return of 6.6% including stock buybacks). Given the sustainability of its profits this continues to represent an attractive valuation.

Following its merger with Allied Waste in 2009, **Republic Services Group** is now the second largest operator in the US waste disposal industry. This should help maintain pricing discipline, given the long term commitment of management to profitability rather than growth. The strategic benefits of the merger are reflected in healthy earnings accretion anticipated over the next few years. The company is seeking to achieve more efficient routing and savings through greater use of its own landfill sites avoiding third party charges. In June it announced strong quarterly results, beating expectations. Margins reached a record 31.7% due to pricing discipline, growing synergies and cost controls. Management are seeing real signs of economic improvement that picked up in March and have remained strong in April, which bodes well for the rest of the year. Republic expects to increase cash returns to equity holders in the second half of 2010, both through dividends (a 5% increase has been flagged) and share repurchases (a \$250-400mm authorisation is expected).

**M&T Bankcorp** has one of the most consistent fundamental track records in the banking industry, generating 12.5% EPS growth on average over the last 15 years. As the global economy emerges from the banking crisis, M&T's steady growth, high profitability model is increasingly attractive. The drivers of future revenue are highly uncertain among many of the larger banks given their reliance on market sensitive businesses and leverage. While M&T's low reliance on fee-based revenue may have been considered a negative in the past, (and possibly in the near term), that attribute should emerge as a positive longer term. With the majority of M&T's future earnings stream reliant on its interest rate spread, the earnings momentum should be visibly strong. M&T is the largest bank by assets that has maintained their dividend to-date. Management does not appear on the verge of cutting the dividend, taking instead the view that dividend policy is a long-term strategy not to be changed after a few tough quarters. Over the long term, the stock has consistently outperformed its peers, driven by a sustainable ROA advantage and effective capital deployment. M&T has been the subject of corporate activity speculation with reports that Spanish Bank Santander is interested in acquiring M&T. While the outcome of these talks remain uncertain we are monitoring developments closely in relation to this.

**Fresenius Medical Care** is the leading player in the \$70bn global dialysis market providing dialysis service to 10% of all patients worldwide and manufacturing 40% of the world's dialysers and dialysis machines. It is well positioned to benefit from stable underlying patient growth of 5-7% per annum, driven by an increasing proportion of

elderly in the population and increasing prevalence of diabetes. At present, Medicare pays a flat fee, known as the composite rate, for a defined basket of dialysis services, and pays on a cost-plus basis for drugs that are administered to dialysis patients. One problem with this funding arrangement is that it provides a financial incentive for higher drug doses. In January 2011, Medicare will shift to a bundled payment system that includes all commonly used drugs and services. Under bundled pricing, Medicare will pay dialysis providers a package price that includes dialysis services, drugs, laboratory tests and a quality of care adjustment. Bundled payments are disproportionately good for the large providers. First, they increase their market power and should help them capture a large slice of the overall dialysis market. Second, large chains are much better placed to manage the risks that come from very high variability in the cost of treating individual patients compared to a small independent clinic which is extremely exposed to risks from case mix. This means that Medicare cannot squeeze the bundled rate too hard. It has to provide some degree of insulation for the case mix risk that is carried by small chains and independents but not Fresenius.

#### Bottom Performers – Contribution by Stocks Held

Bottom 10 Contributing Stocks	Contribution
Walgreen	-0.33%
General Dynamics	-0.31%
Total SA	-0.24%
BNP Paribas	-0.20%
A.X.A SA	-0.16%
Canon	-0.15%
Shoppers Drug Mart	-0.14%
Hewlett-Packard	-0.14%
LG Electronics	-0.11%
Aflac	-0.11%

**Walgreen** reported quarterly earnings below expectations during the month. Its gross margin was weaker due to lower reimbursements from health insurers for drug prescriptions, and selling and administrations expenses which grew faster than sales. Despite the difficult economic background, Walgreen is working very hard to improve the things that are in its control. The company is slowing its store growth from 8% in 2009 to 2.5-3.0% in 2011. In total, this reduces capital expenditure by \$1bn and lowers the earnings drag from new stores (which take about 2-3 years to break even). The “Rewire for Growth” cost-cutting initiative is on track to save a cumulative \$500 million, after costs, in 2010 and a cumulative \$1.0 billion in 2011. The company is rolling a store layout and the group of pilot stores, which has experienced the first set of changes, is showing a lift in sales of 2.6%. The introduction of beer and wine is also boosting sales and are a good traffic draw and lead to a bigger average basket size. The company stands to benefit from a new wave of higher

margin generic drugs coming to the market in 2011/12. It is shareholder focused and has repurchased \$600 million under its \$2 billion share repurchase program (7.4% of market cap) that it commenced last October.

**General Dynamics** has a significant exposure to the US Army, (approximately 25% of total company sales or about 40% of the defence related sales). That exposure has been a key contributor of growth as a result of the intensive ground-based combat in Iraq and Afghanistan. However with pressure for these operations to be wound down, the company's combat business has weighed on investor sentiment in recent times. We believe these fears may be excessive, and the downside to combat systems may be more gradual (the backlog in combat systems was down a modest 4% y/y in 1Q10). The most cyclical element of the company's sales is in respect of its Gulfstream business jet division. Approximately 20% of its earnings will come from commercial aerospace in 2010 but this can climb toward closer to 30% of EBIT within two years as the market for business jets recovers. Gulfstream sees its new G650 as a revolutionary product, creating a new long-range, high-speed, ultra-wide cabin segment. The G650 is specifically targeted at taking the top end of the market back from Bombardier, the only other significant competitor at the very top of the market, which currently offers the Global Express XRS. The recent fall in its share price means the company offers investors exposure to a commercial aerospace recovery but at a multiple in line with a pure defence stock.

**Total's** Q1 results show that production growth has resumed, up 4.5% on the corresponding quarter in 2009. However, the shares were brought down despite the solid showing because, unlike the other key majors, Total did not beat expectations. Strategically it is well balanced between the upstream and downstream, with some chemicals exposure. The company is very confident as to its production guidance for 2010 of 3% growth and 2% annualized over the period 2009-2014. This confidence is justified by the fact most of 2010 production growth is set to come from the ramp up of 5 major start-ups initiated in 2009 (worth the equivalent of c10% of 2008 production) which therefore lessens delivery risk. Total's superior resilience was particularly evident in 2009 thanks to its lower than average cost base. The progressive sale of the 6% stake in Sanofi-Aventis (worth ~€6bn) provides Total with superior financial flexibility, helping the company to maintain and grow dividends, reinvest at the right point of the cost cycle and retain a comfortable level of net debt.

**Axa** is one of the premium franchise stocks in the life sector. It has suffered in recent weeks due to its equity market exposure and outflows from its fund management divisions. However it has a highly regarded management team who have built up a strong track record of successful growth and risk management over the last few years and its current valuation is attractive both relative to its peers and its own history. The company exhibits tremendous

geographic diversity and has successfully built up a resilient core underlying earnings capacity of €4bn to €4.5bn over the years, via increases in scale and diversification (both geographically and by business line). The company has transformed into a truly global insurance company over the past decade, attracting almost 80% of its earnings from 13 countries. While the business is largely focused on life, (63% of 2009 revenue), the Property & Casualty business (30%) has a stabilising influence on group earnings. After a great deal of discussion about the potentially negative impact on the sector of Solvency 2, a much more balanced framework is now emerging, which will give relatively strong credit to size and technicality - two key competitive advantages for Axa. Axa's balance sheet and earnings have recovered materially from a year ago. Concerns around solvency, leverage and the balance sheet should have diminished with a better than expected full-year result across the board. Predominantly focused on life, AXA has lost its traditional premium to peers and is trading at a c.10% discount on 0.7x embedded value, indicating above-average upside potential.

**BNP Paribas's** management has been sensible in capital deployment and the company has come through the credit crisis better than many of its peers. Its pedigree as a top tier bank is exemplified by a strong record of growth and value creation. BNP has very strong core retail banking skills, particularly in cross-selling and value-per-customer maximisation and this is apparent in superior performance both in its domestic market and internationally. Its domestic French retail network is focused on urban, affluent clients. The bank also has rapidly growing franchises in retail banking overseas, specialised financial services such as consumer credit, and a successful bancassurance and asset management business. Management has increased its estimate of annual savings from the Fortis integration to €900m by 2012. It acquired Fortis in 2009 for €9bn giving it a market leading position in Belgium and Luxembourg. The Belgian banking market is attractive with GDP per head higher than in France or Italy. BNP suffered during the quarter from the general sell off in financials and also concerns about French banks' exposure to Greek sovereign debt. While this is likely to be more significant in the case of Societe Generale and Credit Agricole who have Greek subsidiaries, BNP's exposure amounts to €5bn and even in an extreme case of a 50% writedown the loss to its book value would be 4%.

#### Portfolio Activity

There were no new stocks or disposals during the quarter.

#### Regional & Sector distribution

The Portfolio's key active positions on a sectoral basis are its bias toward healthcare and consumer staple stocks and its relatively light weight in financials. The portfolio currently holds no stocks in the utilities sector.

Our investment approach is bottom-up. Therefore we do not deliberately allocate our investments by country or sector on a top-down basis. Country and sector exposure results from our stock selection process.

#### Sector Distribution at 30 June 2010

Sector	Portfolio (%)	Index (%)	Active (%)
Energy	6.0	10.1	-4.1
Materials	0.9	6.6	-5.7
Industrials	12.3	11.2	1.1
Consumer Discretionary	12.0	10.2	1.8
Consumer Staples	21.5	10.5	11.0
Health Care	17.3	10.5	6.8
Financials	11.2	19.6	-8.4
Information Technology	16.0	12.4	3.6
Telecom Services	2.1	4.3	-2.2
Utilities	0.0	4.5	-4.5
Cash	0.8	0.0	0.8

The Portfolio continues to have a substantial exposure to European stocks and is less exposed than the market index to stocks in North America.

#### Regional Distribution

Region	Portfolio weight %	Index weight %	Active weight %
North America	49.6	56.9	-7.3
Europe Ex UK	27.6	20.3	7.3
UK	8.2	9.9	-1.7
Asia-Pacific Ex Japan	3.5	2.0	1.5
Japan	10.3	10.9	-0.6

#### Outlook

If media mentions of double-dip recessions were a leading indicator of problems ahead, we would be in a true crisis. Talk of slipping back into negative economic growth has risen substantially in recent weeks. This has been prompted largely by a downturn in macro data and ongoing structural worries about the sustainability of the recovery. The trend of earnings revisions has also started to slow down. Currently, consensus estimates are calling for 34% global earnings growth in 2010 followed by 19% growth in 2011. We believe this is likely to prove unattainable. Corporate profitability is being boosted by cost cutting, and government stimulus. However both of these factors are likely to unwind due to the limits on the extent to which costs can be trimmed and the clear shift in focus to reining in government deficits. Until recently, cyclical tailwinds have been able to dominate structural concerns, particularly about the extent of corporate and personal indebtedness. Now that those tailwinds are fading,

uncertainty about the sustainability of growth has risen, leading to increased volatility. While we expect a sustained (if weak) growth recovery, markets are likely to remain jittery given the lack of visibility. For equity markets, slower earnings growth expectations need not translate in to market downside. Valuations have room to absorb slower growth expectations and to still allow for market upside. 2011 growth forecasts would need to go negative before the Global P/E ratio would hit 13x, implying a significant margin of safety built into current valuations. The current P/E is only 11x, indicating ample room for multiple

expansion even with lower growth expectations. The portfolio is positioned towards those companies with favourable balance sheet and profitability metrics. Typically they are high RoE, and low leverage companies where EPS and DPS are stable and growing. High quality stocks are starting to outperform low quality stocks following substantial underperformance in 2009 and we expect this trend to continue in the second half of the year.

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#### Compliance Statement

PIML has prepared and presented this information in compliance with the Global Investment Performance Standards (GIPS). Additional information regarding the firm's policies for calculating and reporting returns is available on request.

#### Firm Definition

The Perpetual Wholesale International Share Fund is managed by PI Investment Management Limited (PI). PI is defined as a global equities asset management specialist. PI is a wholly owned subsidiary of Perpetual Limited and is structured as a private limited company. It was incorporated on 21st September 2004 and was authorised by Ireland's Financial Regulator on 18th February 2005.

**Performance Returns:** The returns presented are gross of fees and taxes and net of withholding taxes.

**Benchmark:** The sources of foreign exchange rates may be different between the composite and the benchmark.

**Minimum Asset Level:** We have the discretion to exclude all portfolios below a certain size from their relevant composite. The size cut-off limit has been set at AUD 50,000,000 measured continuously from the PI's date of inception.

**Derivatives:** Derivatives are not generally used in managing our equity portfolio. However, we can use forward foreign exchange contracts or currency hedging purposes.

**Verification:** Verification has been conducted for performance results from 31 March 2005 to 31 March 2008.

**Fee Schedule:** A fee schedule is available on request.