

Adviser update

January 2011

From the desk of the Chief Investment Officer

There were two memorable events for investors in 2010. The European debt crisis overshadowed the first half of the year. The announcement in August by the Chairman of the US Federal Reserve of a second round of quantitative easing had a major positive influence on equity markets during the second half of the year.



James Jordan - Chief Investment Officer

Investing according to Australian Ethical's Charter keeps us out of almost all materials and resources stocks. That made 2010 a challenging year for our domestic equities team. The S&P/ASX200 Materials index returned 12.5% and the Small Resources index returned 30.0%, while the S&P/ASX200 returned 1.6% and the Small Industrials Index returned -1.7%. The Australian Ethical Smaller Companies Trust did very well therefore to return 4.5% for the year (after fees and expenses). The driver of this strong performance was the trusts' holdings of small Australian companies.

Entering 2011 the same major factors loom large. Fiscal austerity in Europe will exert a dampening effect on the global economy, as will a likely continuation of high saving by US consumers. The emergence of inflationary pressures in China suggests that growth there may be restrained in the near future. Very low real interest rates in the US, Japan and Europe are exerting a powerful stimulatory force, both for companies considering capital expenditure and for investors considering the opportunity cost of buying risky assets.

The bottom line for investors in 2011 is a continuation of the heightened uncertainty about economic growth and returns on risky assets that has marked the post-GFC period.

The long term investment outlook for investors in Australian Ethical's products, however, remains robust: the US economy has powerful demographic forces underpinning its future growth prospects, the economic development of China and India has far to go, and shunning carbon risk and investing selectively in renewable energy and efficiency remains a smart bet.

Australian Ethical added to BT Wrap

The Australian Ethical Smaller Companies Trust and the Australian Ethical Larger Companies Trust have been added to the BT Wrap.

This is a key addition for advisers using the BT Wrap to be able to offer their clients an ethical investment option.

While there are some responsible/sustainable funds available on BT Wrap which have a light negative screen, the Australian Ethical trusts have a positive screen that actively seeks investment in growth areas such as renewable and efficient energy, recycling, alternative transport and water technologies.

This positive screen adds a significant level of utility and investor satisfaction that is not offered by other responsible/sustainable funds.

Any advisers who use BT Wrap who would like a presentation or further information about our funds should contact professional@australianethical.com.au or phone 02 6201 1926.

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Recommended rating for Smaller Companies Trust

The Australian Ethical Smaller Companies Trust had its Recommended rating from research house Lonsec restored in September. The Larger Companies Trust has also had its Investment Grade rating from Lonsec reinstated. These trusts had been on fund watch following the departure of the previous Chief Investment Officer.

Australian Ethical believes the reinstatement of the original ratings for these trusts, and the Recommended rating in particular, is a strong indicator of the strength of its investment team and a reflection of the superior financial performance of the funds over a number of years.

The Smaller Companies Trust continues to outperform its benchmark ASX Small Industrials Index, and with a much lower volatility. Over five years to the end of December 2010 the trust has returned 7.8% p.a. compared to the benchmark's -0.9% return. Since the trust's inception in September 1994 it has produced a return of 9.8% p.a. against the benchmark return of 6.6%.

Wholesale management fees introduced

Australian Ethical has introduced a capped wholesale management fee for its Smaller Companies Trust. The wholesale management fee of 1.35% per annum is a discount on the retail management fee of 2.13%. The Larger Companies Trust has had a wholesale management fee for a number of years. The Climate Advocacy Fund also has a wholesale management fee of 0.85% per annum.

The wholesale fee is available for direct investors with over \$500,000 invested across all our managed funds, and for investments through wraps and platforms. Australian Ethical funds are available through a number of major platforms including BT Wrap, Asgard, Macquarie Wrap, Colonial First Wrap, Freedom of Choice, MLC Navigator and Netwealth.

New company profiles

Australian Ethical continues to add leading companies to the global smart energy themed International Equities Trust. Recent additions to the portfolio include smart grid company EnerNOC and solar energy companies Centrotherm Photovoltaics and Trina Solar.

EnerNOC offers energy and carbon efficiency services to clients. It is the world's largest provider of demand response services, which help electric grid operators regulate supply and demand. Demand response services help reduce peak demand periods in electricity use. This results in savings in generation, transmission, and distribution costs. EnerNOC has also developed a range of software that allows clients to monitor their energy consumption and carbon emissions.

Founded in 1976, Centrotherm Photovoltaics provides equipment and services for the production of solar cells and solar silicon. The company has over 1000 employees globally, and generates the majority of their revenue from sales to customers based in Asia. One of the company's subsidiaries manufactures speciality products for the treatment of hazardous material produced as a by-product of solar cell and semi-conductor manufacturing.

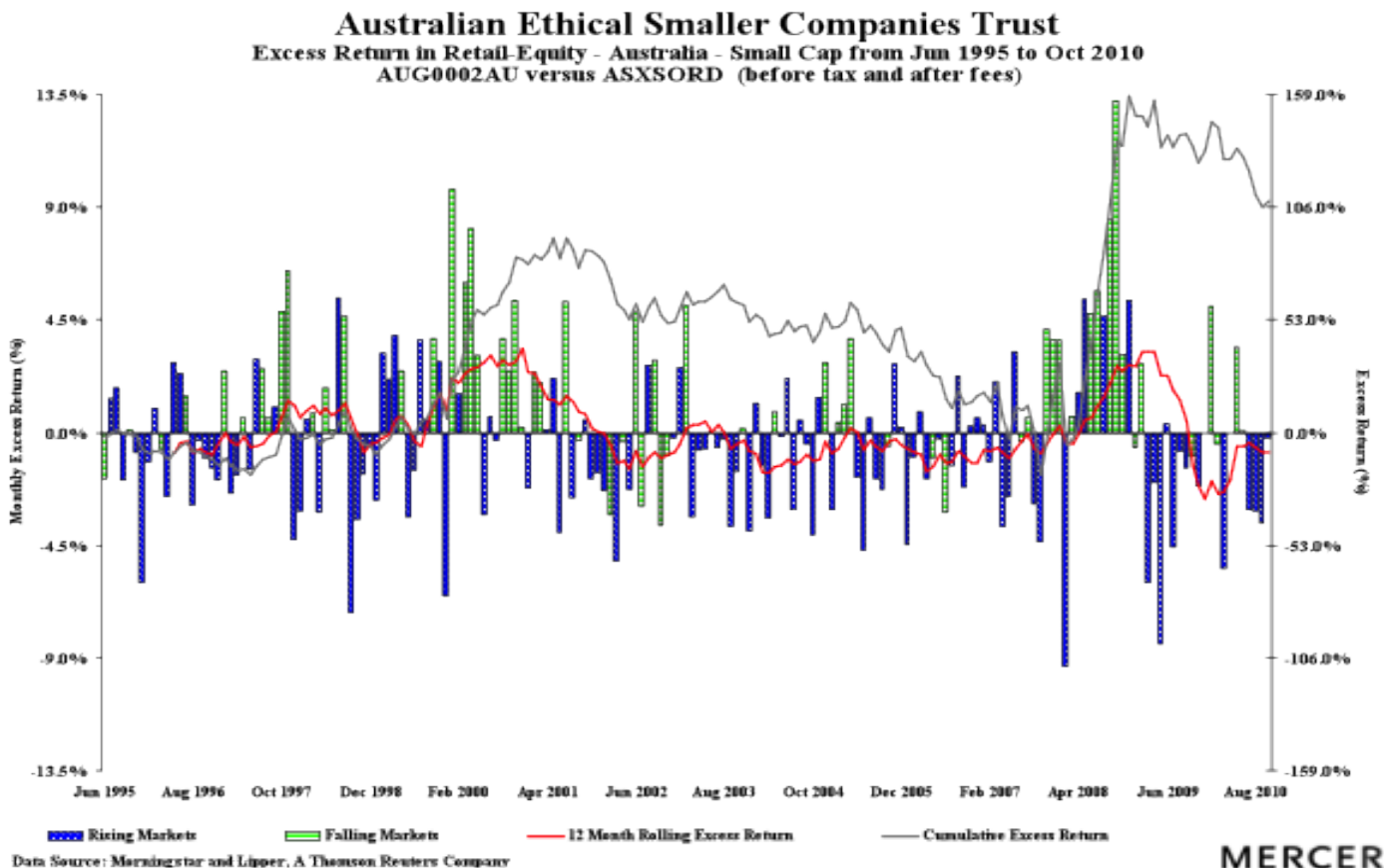
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Smaller Companies Trust – adding value to your portfolio

This chart helps explain the role the Australian Ethical Smaller Companies Trust can play in a portfolio. It shows whether the fund (net of fees) has added value above the ASX S&P Small Ordinaries Index. The red line then indicates the rolling 12 month out-performance. The grey line shows the cumulative excess performance.

What is evidenced clearly is that the fund tends to add the most value, most often during down markets, while also delivering a very strong cumulative result for investors.



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First shareholder resolutions on climate change

The first shareholder resolutions proposed by Australian Ethical's Climate Advocacy Fund were officially announced in September 2010. Resolutions were submitted to the AGMs of Aquila Resources, Paladin Energy, Oil Search and Woodside Petroleum.

The resolutions focus on these companies describing their carbon emissions footprint, having a plan to reduce their emissions to a stated, targeted level, and ensuring their investment decisions and balance sheet valuations are based on stated reasonable assumptions about future carbon emission pricing and regulation.

The aim of the resolutions is to protect long-term investor returns by putting the spotlight firmly on the gaps in knowledge and preparedness of companies to manage the long-term risk of climate change.

Even in the absence of a domestic price on carbon pollution, the impacts of the global move to a low carbon economy are already being felt. Emissions intensive companies and major polluters that aren't prepared for the rapidly emerging low pollution economy risk becoming uncompetitive.

Paladin and Aquila held their AGMs in November 2010. Both companies chose not to allow the resolutions to be voted on at their AGMs.

Although both companies chose not to have the resolution voted on, the proposed resolutions and supporting material were included with the AGM papers sent out to shareholders. As a result, more than 25,000 Paladin shareholders and 4,000 Aquila shareholders were informed of the climate change risks confronting their company.

climate ADVOCACYfund

Following their AGMs both Paladin and Aquila have indicated that they will provide greater disclosure around carbon emissions.

Oil Search and Woodside will be holding their AGMs in the first half of 2011. Oil Search have already indicated they will allow the resolution to be voted on at the AGM. The positive response from Oil Search puts the responses from Paladin and Aquila into context.

The putting of resolutions by shareholders, particularly on environmental issues, is unique in Australia. These are the first resolutions to be submitted to Australian companies on environmental issues for at least five years. The mixed response from these companies having to deal with this for the first time is not unexpected.

For more detailed information about the resolutions visit www.climateadvocacyfund.com.au.

The Climate Advocacy Fund has outperformed its benchmark since the funds inception in February 2010. The Climate Advocacy Fund has produced a return of 8.8% to 31 December 2010, compared to the benchmark S&P/ASX 200 return of 5.9%.

The Fund has recently been added to the Freedom of Choice menu.

If you or your clients would like to know more about the Climate Advocacy Fund please contact Adam on 02 6201 1926 or email adam@australianethical.com.au.

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Returns

Returns to 31 December 2010	3 mth	1 yr	3 yr (p.a.)	5 yr (p.a.)	Since inception (p.a.)
Smaller Companies Trust	9.3%	4.5%	1.1%	7.8%	9.8%
S&P/ASX Small Industrials	5.5%	2.2%	-11.2%	-0.9%	6.6%
Larger Companies Trust	2.5%	-2.8%	-7.2%	-0.6%	7.7%
Melded Benchmark	1.5%	-2.0%	-7.9%	-0.2%	5.9%
International Equities Trust	-3.0%	-6.8%	-13.1%	-	-10.8%
MSCI World (AUD)	2.9%	-1.4%	-9.1%	-	-8.6%
Balanced Trust	2.6%	2.6%	-2.8%	1.2%	6.5%
Morningstar Multisector Balanced	n/a	n/a	n/a	n/a	n/a
Property Trust	0.6%	12.9%	-	-	2.6%
Mercer Unlisted Property Index	n/a	n/a	-	-	n/a
Climate Advocacy Fund	2.7%	-	-	-	8.8%
S&P/ASX 200 Accumulation	4.4%	-	-	-	5.9%