



Inside the Investment Team...

The dangers of short term-ism

In recent months, the performance of our key portfolios has lagged the relevant benchmarks. Here we look at why this is happening, and where we see the portfolios heading in the coming years.

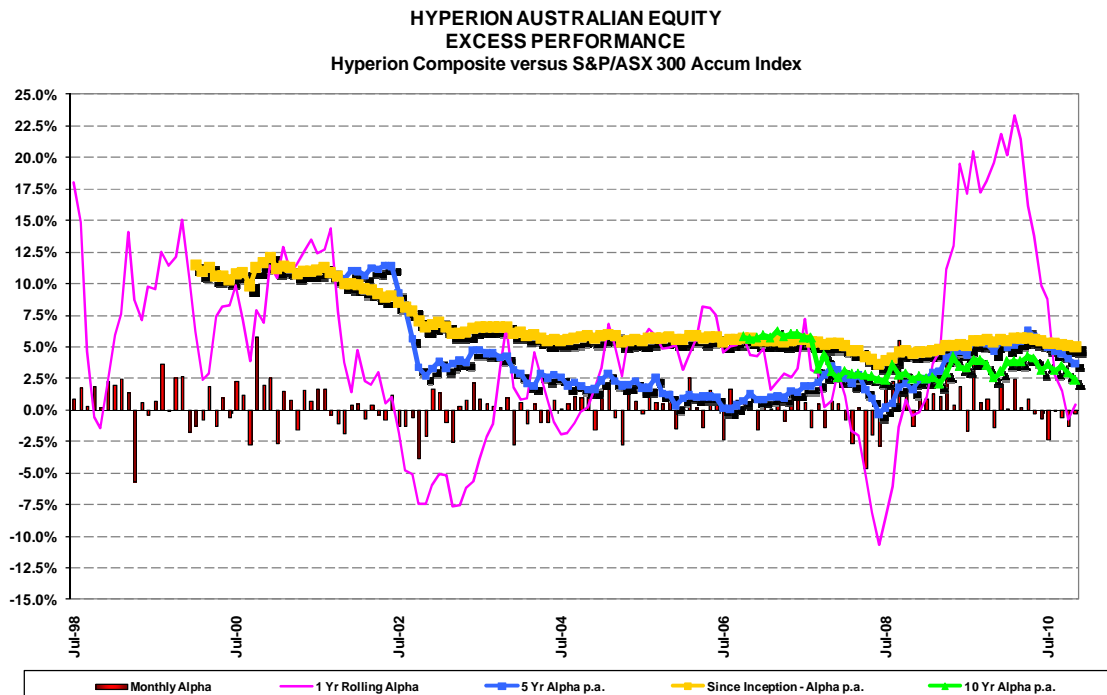
The first thing we would like to stress is that the current situation is a demonstration of our investment philosophy in action. It also sounds a salutary warning about 'short-termism' - the view that short term performance is the only thing that matters - which has crept into some investment management circles in recent years.

To understand our investment philosophy, it is first necessary to understand our central investing goal: and that is, to produce attractive returns over rolling five year periods. To do so, we invest in the highest quality organic growth businesses available in the relevant universe. And, as a result, our portfolios are normally quite different in composition from the relevant benchmark.

For our investors, this approach has produced reliable long-term outperformance - and we are confident that it will continue to do so.

Our positive long term outlook continues

These returns are illustrated in the following chart. As it clearly shows, while periods of underperformance do occur and are to be expected, they have been temporary and dominated by larger and much more prolonged periods of outperformance which we believe will continue in the future.



Why? There are several reasons including:

- the trend to higher intrinsic values driven by robust EPS growth;
- attractive and sustainable P/E ratios for the key portfolios;
- P/E ratio premiums that are below their historical averages; and
- the expected winding back of current cyclical headwinds in the medium term.

In fact, in our view, despite the appearance of underperformance, we think the long-term **intrinsic value of the portfolio has actually increased**, broadly in line with earnings growth over the past year. For example:

- in the 12 months ended 30 June 2010, the median EPS for the broad-cap portfolio increased by approximately 13% and DPS increased by 11%;
- based on our current forecasts, EPS and DPS growth for our key portfolios should continue to run at double digit rates both in the short-term (next 12 months) and over the next five years; and
- we expect this strong EPS growth to be driven by average revenue growth over the next five years of 11% (around two times nominal GDP).

When looking at these forecasts, it's important to understand that they are based on the belief that, in the long-term, prices will reflect business value, but that over the short to medium-term, price and value can diverge quite substantially.

Short term headwinds affecting current performance

Which brings us to the next question: why *have* the recent values of our portfolios been under pressure?

The answer is that there are several temporary cyclical trends that have been creating headwinds for our portfolios over the past few months.

These include the strong Australian dollar, higher commodity prices and difficult retail and stock market conditions.

The higher Australian dollar has been a net drag on the performance of our large and broad cap portfolios because of our higher exposures to global growth stocks such as Cochlear, IRESS and Macquarie - all of which have revenues linked to foreign currencies. Our large exposure to these types of stocks is because they have significant long-term organic growth opportunities outside Australia. In addition, Wotif's share price has also been adversely affected by, among other things, the adverse effect of the strong Australian dollar on demand for domestic accommodation.

Higher commodity prices have also significantly affected our portfolios' relative performance because they have below benchmark exposures to the resources sector and no exposure at all to the small and medium sized speculative resource stocks that have produced strong returns in recent months. Why do we take this position? Because these stocks tend to lack the business quality and predictability of the long-term organic growth potential we require.

Difficult retail trading conditions have adversely affected our short-term investment performance because of our above benchmark exposure to consumer discretionary stocks. We maintain these exposures because we are confident that strong retail rollout stories (e.g. The Reject Shop) and structural switch stories (e.g. Wotif) will make strong contributions to overall investment performance over the long-term.

Why leave the benchmark?

We have already mentioned that, to achieve consistently attractive long term returns, we believe it is necessary to construct portfolios that are different from industry benchmarks.

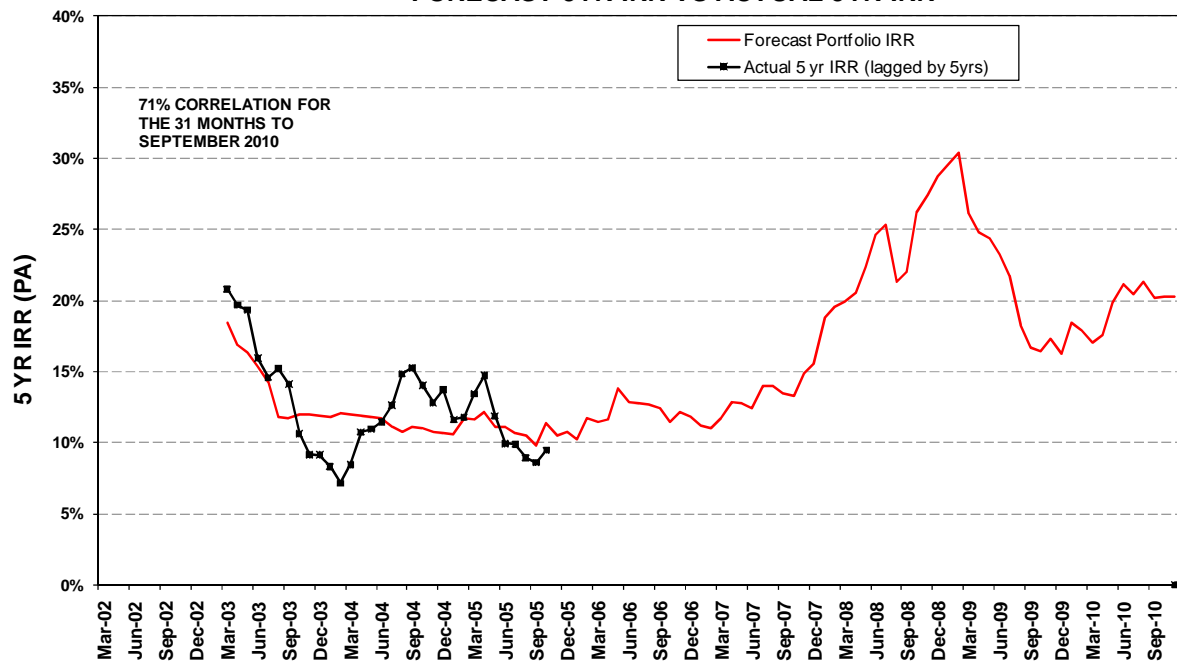
The reason for that is because the very nature of indices is short term. Constructed based on short-term liquidity and market capitalisation factors, they do not rely on the quality of the underlying businesses and likely future stock returns.

Our portfolios, on the other hand, tend to comprise stock weights that are outside the index-based weights. This explains why our short-term alpha is volatile at times and occasionally negative. However, given the long-term investment horizons of our clients, we believe that short-term volatility is a small price to pay to achieve the much more important goal of consistent, attractive long-term returns.

Looking ahead: rosy returns forecasted

Finally, let's turn to the future. Our record in forecasting likely total returns over rolling five year periods has been good since we started tracking the relevant data in early 2003, as chart below shows. And the current forecast five year IRR for our key portfolios is 20% - a clear sign that our clients are likely to experience attractive returns over the next five years.

FORECAST 5YR IRR VS ACTUAL 5YR IRR



The link between investor patience and strong portfolio returns is a well known one. To find out more, contact us for the article from The Journal of Portfolio Management: *Is Patience a Virtue? The Unsentimental Case for the Long View in Evaluation Returns.*

Short-term fluctuations belie long-term outperformance

Following the AGM season, the investment team remains confident in its current portfolio holdings and weightings. Short-term portfolio performance continues to be influenced by sharp price movements in different market sectors. For example, the Industrials sector has been broadly flat over the past two months while the Materials sector has been buoyant (11% growth).

Despite these short-term fluctuations, the long-term outlook remains attractive as the portfolio's five year IRR remains elevated at 20% pa. Traditional short-term investment metrics (forward PER at below 15x and dividend yield nearing 5%) are also strong relative to historical portfolio averages. The investment team believes the portfolio will produce EPS growth and ROC levels well above the market over our five year investment horizon.

Quality stocks help monthly performance

Sector positions in the Hyperion Australian Equities Composite and the Hyperion Australian Equities ASX 300 Composite remained steady during the month. The best performing sectors in an absolute sense were Health Care, Telecommunications and Energy. The biggest laggards were the Consumer Staples, Consumer Discretionary and Banking Financials sectors. The largest contributors to relative performance during the month were Cochlear (+10.18%), REA Group (+15.12%) and WorleyParsons (+9.8%). The largest detractors from active performance during the month included SEEK (-8.3%), BHP Billiton (+1.96%) and not owning Telstra (+5.24%).

At its recent AGM, SEEK provided a trading update. The core employment business in Australia and overseas continues to show strong growth but profit growth in the company's education business in Australia has slowed (15% to 20% of earnings). This is partly due to a cyclical slowdown in revenue and partly as a result of increased investment in business infrastructure.

Cochlear rallied strongly during the month. The share price movement came on the back of the Advanced Bionics global recall of its HiRes 90k cochlear implants; a competing product to Cochlear's Freedom Implant. The recall was initiated following numerous complaints of unexplainable product malfunctions. The investment team believes that this malfunction is a significant setback for Advanced Bionics and its new owner Sonova, as reputation is a key success factor for these companies. This should lead to a substantial increase in the market share for Cochlear over the next few years.

Performance	1 mth	6 mth	1 year	2 year	5 year	10 year
Hyperion Australian Equities Composite	0.29	2.63	3.80	25.67	8.28	10.52
Excess Performance over S&P/ASX 300 Accumulation Index	1.26	-3.70	1.99	9.52	4.03	2.68

Hyperion Australian Equities Composite Top 10 Stock Holdings		
Stock	Absolute Weight	Active Weight
Cochlear	7.52%	7.12
Platinum Asset Management	6.94%	6.83
RIO Tinto	6.74%	3.35
Seek	6.33%	6.13
BHP Billiton	6.11%	-6.85
Commonwealth Bank of Australia	6.03%	-0.73
Woolworths	5.08%	2.10
Macquarie Group	4.59%	3.49
WorleyParsons	4.36%	3.90
Sky Network Television	4.25%	4.25

Performance	1 mth	6 mth	1 year	2 year	5 year
Hyperion Australian Equities ASX 300 Composite	0.47	1.43	1.96	25.02	9.74
Excess Performance over S&P/ASX 300 Accumulation Index	1.44	-4.90	0.14	8.87	5.49

Hyperion Australian Equities ASX 300 Composite Top 10 Stock Holdings		
Stock	Absolute Weight	Active Weight
Seek	7.74%	7.55
Cochlear	7.52%	7.12
RIO Tinto	7.41%	4.02
Commonwealth Bank of Australia	6.99%	0.23
BHP Billiton	5.90%	-7.06
Macquarie Group	5.59%	4.48
Platinum Asset Management	5.50%	5.39
Woolworths	5.41%	2.43
AMP	4.79%	3.83
Woodside Petroleum	4.57%	2.32

Small miners are market favourites but beware the long-term fundamentals

The Hyperion High Conviction Small Growth Companies Portfolio outperformed the S&P/ASX Small Ordinaries Accumulation Index during November. The portfolio returned 1.89% versus the benchmark return of 0.53%. This was a strong result considering the buoyancy of the Materials sector.

The sectors recording the biggest positive movements during the month included Banks, Materials and Non-Bank Financials. The worst performing sectors included Consumer Staples, Utilities and Consumer Discretionary. The largest contributors to relative performance during the month were REA Group (+15.12%) and Navitas (+9.66%). The largest detractors from active performance during the month included The Reject Shop (-7.55%) and Carsales.com (-2.95%).

The portfolio's sector exposure is a direct result of our bottom up portfolio construction process. The process focuses on companies with high returns on equity, predictable earnings and competitive advantage in their industries. The junior miners do not generally meet this investment criteria and the fund has no direct resources exposure. The portfolio does invest in quality mining services companies, although the portfolio's current exposure is limited to Campbell Brothers (CPB).

Having no resources exposure means the portfolio will underperform in the short term when the resources sector performs well, and will outperform when resources are weak (all other things being equal). However, over the long term we believe performance will be driven by the quality of a franchise and its ability to generate sustained growth in earnings and high returns on capital. The Materials sector returned +3.9% in November.

Some examples of strong share price appreciation included Cudoco (CDU; +55.7%), Intrepid Mines (IAU; +37.8%) and Linc Energy (LNC; +34.0%). In contrast, the Industrials sector was flat for the month.

Performance	1 mth	6 mth	1 year	2 year	5 year
High Conviction Small Growth Companies Portfolio	1.89	7.45	10.16	40.80	12.33
Excess Performance over S&P/ASX Small Ords Accumulation Index	1.36	-9.35	0.04	9.22	7.92

High Conviction Small Growth Companies Portfolio Top 10 Stock Holdings		
Stock	Absolute Weight	Active Weight
IRESS Market Technology	9.65%	8.82
Reckon	9.46%	9.46
REA Group	8.77%	8.13
Wotif.com Holdings	8.20%	7.66
Sky Network Television	7.96%	7.96
The Reject Shop	7.25%	6.83
Platinum Asset Management	7.18%	6.00
Carsales.com	6.89%	6.44
Count Financial	6.46%	6.46
Navitas	6.25%	5.47

Recent Mandate Wins and Remaining Capacity

Some of our institutional clients topped up their existing mandates during November, a sign of confidence in Hyperion's long-term performance prospects and taking advantage of the current window of opportunity afforded by market valuations. Similarly, retail inflow continues at a steady pace. This takes our total FUM to \$2.5 billion compared to our most recent capacity calculation of \$3.5 billion.

Product Capacity		
PORTFOLIO	UNIVERSE	REMAINING CAPACITY
High Conviction Small Growth Companies	Small Ords	\$0.05b
Australian Equities ASX 300 Composite	ASX 300	\$0.8b
Australian Equities Composite	All Ordinaries	Soft closed

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