# MAY 2006 INVESTOR REPORT

## FUND PERFORMANCE*

| | Oct-05 | Nov-05 | Dec-05 | Jan-06 | Feb-06 | Mar-06 | Apr-06 | May-06 | YTD |
|---|---|---|---|---|---|---|---|---|---|
| **Cadence Capital Limited** | 0.10% | 1.41% | 6.39% | 7.57% | 4.23% | 5.04% | 5.60% | 2.25% | **37.34%** |
| **All Ordinaries Acc Index** | -3.83% | 4.35% | 3.09% | 3.65% | 0.70% | 4.81% | 2.40% | -4.34% | **10.86%** |
| **Small Ordinaries Acc Index** | -3.74% | 2.98% | 1.45% | 3.76% | 2.13% | 6.32% | 1.02% | -4.02% | **9.86%** |

*Before Performance Fees and Tax

## PORTFOLIO SECTOR ANALYSIS

| Sector | Long | Short | Total |
|---|---|---|---|
| Materials | 35.49% | -13.41% | 22.08% |
| Software & Services | 15.49% | -6.78% | 8.72% |
| Energy | 14.78% | -1.00% | 13.78% |
| Commercial Services & Supplies | 13.85% | | 13.85% |
| Insurance | 8.32% | -1.62% | 6.70% |
| Capital Goods | 6.96% | | 6.96% |
| Media | 5.84% | | 5.84% |
| Unspecified | 5.41% | | 5.41% |
| Health Care Equipment & Services | 4.71% | | 4.71% |
| Banks | 3.58% | | 3.58% |
| Real Estate | 2.83% | -1.97% | 0.86% |
| Diversified Financials | 2.46% | | 2.46% |
| Consumer Services | 1.56% | -3.34% | -1.78% |
| Telecommunication Services | 1.09% | -0.19% | 0.91% |
| Retailing | | -1.79% | -1.79% |
| **Gross Exposure** | **122.37%** | **-30.09%** | **92.28%** |
| **Net Cash / (Debt)** | | | **7.72%** |

Cadence Asset Management Pty Ltd ACN 106 551 062
Level 11, 131 Macquarie Street, Sydney NSW 2000 Australia
Telephone +612 8298 2444, Facsimile +612 8298 2499
Email: info@cadencecapital.com.au

## PORTFOLIO EXPOSURE ANALYSIS %

| | Oct-05 | Nov-05 | Dec-05 | Jan-06 | Feb-06 | Mar-06 | Apr-06 | May-06 |
|---|---|---|---|---|---|---|---|---|
| **Equity Long** | 14.9% | 68.0% | 85.9% | 81.9% | 91.5% | 96.6% | 114.9% | 122.4% |
| **Equity Short** | 2.5% | 2.7% | 0.0% | 2.3% | 10.1% | 16.8% | 13.4% | 30.1% |
| **Gross Exposure** | 17.4% | 70.8% | 85.9% | 84.3% | 101.6% | 113.4% | 128.3% | 152.5% |
| **Net Exposure** | 12.4% | 65.3% | 85.9% | 79.6% | 81.3% | 79.8% | 101.5% | 92.3% |

## MARKET AND COMMENTARY

Cadence Capital Limited closed on the 31st May 2006 with a Net Tangible Asset Backing (NTA) of $1.32027 pre tax and fees and $1.18392 post tax and fees. To get weekly estimates of the NTA for Cadence Capital Limited please visit www.cadencecapital.com.au

During the month of May, Cadence Capital Limited returned a gross performance of 2.25% compared to a fall in the All Ordinaries Accumulation Index of 4.34% and a fall in the Small Ordinaries Accumulation Index of 4.02%. The fund finished the month 122.4% long, 30.1% short and with a Net Long Exposure of 92.3%.The net exposure of the fund for April was 101.5%.

The Australian share market had a pull back in May, with the All Ordinaries index closing down 4.3% for the month, and down 6.8% from the record high set earlier in the month.

Over the past few months, and particularly in the month of May, we have substantially reduced our 'long exposure' and increased our 'short exposure' to protect our assets in a falling market, and more importantly, to profit from falling share prices. As a result our fund was up 2.3% for the month of May and outperformed the All Ordinaries Accumulation Index by 6.6%. Our emphasis is now on potentially benefiting from falling share prices by further reducing our long exposure and increasing our short exposure.

This month I saved an article from the Australian Financial Review (AFR) that appeared in the newspaper on the weekend of 6 -7th May 2006 titled 'Debt'. The accompanying illustration showed a figure bearing a heavy burden on his shoulders and the burden was titled 'Debt'.

The AFR article was written on the weekend following the most recent 25 basis point rise in interest rates by the Reserve Bank of Australia. The latest interest rate rise has put beyond doubt, in our minds at least, the fact that we are now living in an environment of rising interest rates. This environment is very different to that experienced over the last 18 years, a period of extended, falling interest rates. The AFR graphically illustrated a number of facts which bear closer scrutiny.

The first is that household debt is now at 150% of household disposable income, three times the level in the early 1980's. The second important fact is that 'Interest Paid' as a percentage of household disposable income is running at 11%, up from 6% in the early 1980's. In addition,

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household saving as a percentage of household disposable income has fallen from around 15% in the early 1980's to (-3%) more recently. All of these figures point to high household debt levels, high interest repayment levels and low household savings levels. In a falling interest rate environment we might gloss over these numbers but in a rising interest rate environment these statistics are particularly concerning.

As interest rates rise off a high debt base, interest repayments will rise significantly as a percentage of household disposable income, and these household disposable incomes are after tax figures. If we calculate the effect of these interest rate rises in pre tax dollars the numbers look even worse. It is evident that should interest rates continue to rise, households will experience significant hardship in repaying these higher rates of interest. The requirement for more household income will in turn lead to wage pressure, which in turn leads to inflation and as we know inflation generally leads to higher interest rates. The cycle that has moved in favour of asset prices for the last 18 years may well start to move against us for a prolonged period of time.

It is against this backdrop that we reiterate the views we have expressed in our previous newsletters. In this rising interest rate environment, asset prices in general are under pressure including; property, bonds and equities. More specifically, interest rate sensitive assets suffer the most such as property, financial services companies and industrial companies exposed to large cost pressures and high levels of debt. Consumer discretionary spending slows as do most other forms of non essential expenditure. Assets with some inflationary hedge do benefit in this environment including; commodities and resources companies in general, as well as industrial and service companies that have pricing power or are monopoly or duopoly suppliers of essential goods and services.

It is not surprising that resource companies are currently big beneficiaries of an emerging inflationary environment. With commodity prices having risen drastically over the past two years these companies are experiencing an extremely profitable period. It was interesting to note a London Financial Times article on the 5th June 2006, in which it was estimated that mining company profits rose 59 per cent to $45 billion last year, as commodity prices rose more quickly than costs. Revenues rose a more modest 25 per cent to $222 billion illustrating how leveraged resource companies are to higher commodity prices. We note that after such strong and prolonged rises in commodity prices the resource market is currently experiencing significant volatility and during the month of May we have reduced our exposure in this area.

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