

River Capital Credit Fund

Quarterly Report - 30 June 2011

Performance as at 30 June 2011

	Month (%)	Quarter (%)	1 year (%)	Inception (p.a. %)
River Capital Credit Fund ¹	0.24	1.89	17.52	13.25
Performance Benchmark	0.51	1.55	6.40	6.42
RBA Cash Rate	0.39	1.17	4.67	4.56
UBS Composite (All Maturities) Bond Index	0.55	2.33	5.55	6.84

Note 1: Fund returns are unaudited and are after management fees but before performance fees.

OBJECTIVES

The River Capital Credit Fund's objective is to provide a reliable and consistent income stream with a high degree of capital security over the medium term. We invest in investment grade rated securities only, targeting the best risk-adjusted returns with a focus on subordinated securities issued by the strongest banks, insurers and corporates around the world. The Fund is absolute return focused, investing in wholesale institutional markets globally. All investments are fully hedged back to AUD.

OVERVIEW

We are pleased to report an increase in the Fund's unit price from \$0.9863 at the beginning of the financial year to \$1.1175 at the end of the financial year. After allowing for the mid-year distribution of 3.88 cents per unit, the overall return to investors for the financial year was **17.52%**. Importantly, we achieved this return by investing in only investment grade securities issued by high quality companies including ANZ Bank, Commonwealth Bank and Rabobank.

The distribution for 6 month period to 30 June 2011 is expected to be approximately 4 cents per unit, making the total distribution for the year approximately 7.88 cents per unit, or a **cash yield of some 8%** on the 1 July 2010 unit price. The balance of the return of 9.52% reflects the increase in value of the Fund's investment portfolio during the financial year.

Such returns are above what would traditionally be expected from our low risk, buy-and-hold strategy. The recent volatility has allowed us to capture opportunities for our investors, which has enhanced our returns. We continue to see similar opportunities allowing us to purchase investment grade securities, of high quality companies, offering AUD returns of 9%-11% p.a and sometimes higher.

COMMENTS

The 2nd quarter of 2011 proved to be volatile with the fiscal state of European sovereigns being the primary source of consternation. The quarter began inauspiciously as Portugal was forced to accept a bailout underwritten by the EU and IMF.

The situation in Greece deteriorated markedly during the 2nd quarter, culminating with crucial votes in the Greek parliament in late June, which only just reached the majority required to pass bills approving the budget cuts and asset sales necessary to release the next tranche of the EU/IMF bail-out package. A failure of these measures being passed would have led to an imminent Greek default.

European politicians are seeking a solution that may not technically be considered a default. But whatever coy or officious sounding name the final debt management plan is given, the outcome is going to be the same: an effective default where bond holders lose value.

Despite the protests of Eurocrats pointing the finger at financial markets and hedge funds for the sovereigns' difficulties, responsibility for the debt load lies at the politicians' feet, and only politicians have the power to solve it.

The fundamental disconnect seems to be that European sovereigns are suffering from a solvency problem, which the politicians are trying to solve by providing liquidity. Liquidity will avert a default in the near term, but there is not enough liquidity to satisfy the cumulative needs of Greece, Portugal, Ireland, Italy and Spain. The only option is to reduce debt. Yet these countries are running budget deficits which increase the debt, and they have anaemic growth which hampers their ability to increase revenues to pay off the debt.

Also of note in the quarter was a marked downturn in the US data releases. Building starts, housing data, GDP growth, the ISM index, and job numbers all consistently came in below expectations. Only time will tell whether this is a "soft patch" or the start of something more serious.

HOW DOES THIS VOLATILITY AND THE POTENTIAL FOR A SOVEREIGN DEFAULT IMPACT THE CREDIT FUND?

With capital preservation as our founding tenet, the first thing we do is to immediately exclude from our universe of potential investments any company which is domiciled in, or has large exposures to, any country suffering from an unmanageable debt load. No doubt we will miss some potentially attractive yields by taking this approach, but the risks are currently skewed heavily to the downside.

More importantly, such volatility causes market wide risk aversion which means we can find investments offering returns of greater than 9% provided by companies such as NAB, CBA & Rabobank, without having to take on any excessive risks.

Despite the obvious risks of peripheral Europe, other parts of Europe, Scandinavia, and elsewhere around the world, continue to offer a low risk environment with stable fiscal outlooks, manageable (or non-existent) government debt loads, and have institutions whose asset bases are largely domestically focused. In the new world of "Basel III", banks will struggle to achieve the same Return On Equity that they did prior to 2008. But the debt and hybrid securities, higher up the capital structure, become increasingly secure as a result.

No doubt a sovereign default and/or the preceding nervousness has the potential to cause some mark-to-market volatility in the Credit Fund's unit price. However, as long as we remain invested in only the most creditworthy and solvent issuers, we can have confidence that we will continue to receive a reliable & consistent income stream, and that we will get our money back on our investment, irrespective of short term price swings.

Overview

Trustee	River Capital Pty Limited
Auditor	Deloitte

Fund Information

Management Fee	0.85% pa
Performance Fee	15% of excess over Benchmark

Contact

Josh Ackman	+61 3 9825 1111
josh@rivercapital.com.au	

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We currently hold an overweight position in cash & also in securities with minimal risk for price volatility (such as 11 month ANZ securities). This will enable us to both mitigate volatility in the near term and also to react swiftly to opportunities as they arise.

OUTLOOK and OUR INVESTMENT PROCESS

At the heart of the Credit Fund is a desire to provide our investors with the highest quality risk adjusted returns, which they would otherwise be unlikely to access themselves.

The challenges an average investor faces when trying to invest in fixed income can be significant. Most companies have many different fixed income securities on issue, which they usually issue into various investor bases globally, and in multiple currencies. Fixed income securities trade in "Over The Counter" markets. There is no central exchange to buy fixed income securities, as one might when buying a BHP share. Fixed income investments are often held in small parcels, by a diverse range of investors. Each fixed income investment also has its own unique legal documentation and risks. The sum of all these factors means that the best fixed income returns are available only in institutional markets, and usually outside Australia.

SO HOW DO WE ACHIEVE OUR AIM?

1: The first, and most important, question we ask is whether we are comfortable with a company's creditworthiness. Are we sure that we will get our money back? We begin a thorough historical financial analysis: capital ratios, debt ratios, earnings, exposures to troubled industries, non-performing loans, etc. We call the company to speak with the CFO/Treasurer and Investor Relations, we read multiple broker & rating agency reviews, we scour websites and the media for any news, and we access our network of relationships globally.

2. Once we are comfortable with a company, we need to identify the best fixed income security to invest in. Most companies have hundreds of bonds and loans on issue. These range from secured, senior unsecured, senior subordinated and junior subordinated, often issued in multiple currencies. Using both proprietary analytics & established relationships, we scan the fixed income universe. We calculate the AUD equivalent yield available on each investment to aid the comparison, and to identify the single best investment.

3. We perform a thorough legal analysis of that investment. Not all bonds are created equally. Each fixed income security has an individual prospectus and legal documentation. Some have covenants such as dividend stoppers or pushers, or negative pledges, which enhance, or detract from, an investment's attractiveness. Bonds issued in different countries' offer features or risks unique to that country, such as the Alternative Coupon Satisfaction Mechanism in the U.K., or loss absorbency in Germany.

4: The investment opportunity is then presented to our Investment Committee, for further oversight and scrutiny.

5: Finally we need to find the selected investment at the best price, and put in place any required hedging back to AUD. A European investor can have a different perspective on an Australian company relative to an Australian investor. This can result in significant price dislocations for the same security in different domiciles. We use this to our advantage. Utilising our network of relationships globally we not only find the investment we're after, but we find it at the cheapest possible price. We then work with major investment banks to tailor a bespoke currency and interest rate hedge for each

investment. All investments are fully hedged back to AUD so that our investors are not taking on currency risk.

IS SUCH AN INTENSIVE PROCESS SCALABLE?

Probably not if one's goal is to solely to increase Funds Under Management. But our goal is to be the best, not the biggest. We ensure that each investment meets our stringent criteria, and we will only take accept investment applications when we are confident we can deliver what we promise, without diluting existing investors.

OUR NEW WEBSITE (www.rivercapital.com.au)

We have given our website a much needed overhaul. Monthly unit prices for the Credit Fund, as well as for the Growth Fund and Bellwether Fund can now be easily accessed, and we have added some additional features to allow existing and potential investors to access documents, newsletters, monitor upcoming events, and view a selection of relevant news stories.

ANNUAL INVESTOR MEETING

All existing and potential investors are welcome at our Annual Investor AGM, 5pm on Thursday 28th July at the Como Hotel, Toorak Rd, South Yarra in Melbourne. Keynote speaker is Bevan Slattery, the Managing Director of 'Next DC'. We hope to see you there.

Portfolio Profile

Average S&P credit rating	A+
Modified duration to first call	2.8 years
Current cash holdings	10.6%
Current number of securities	11
Suggested investment timeframe	At least 3 years

Maturity/First Call Schedule

Maturity/First Call Schedule	Weight (%)
Cash and Equivalents	10.6%
0 to 2 years	26.1%
2 to 5 years	40.5%
5+ years	22.8%

Country of Issuer

Country of Issuer	Weight (%)
Cash and Equivalents	10.6%
Australia	70.7%
United Kingdom	9.0%
France	4.7%
Netherlands	5.0%

Largest Portfolio Holdings

Largest Portfolio Holdings	S&P Issuer Rating
ANZ	AA
Commonwealth Bank	AA
QBE	A
National Australia Bank	AA
Rabobank	AAA

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