

FAT UPDATE

FAT PROPHETS AUSTRALIAN SHARE INCOME MODEL PORTFOLIO – SEPTEMBER QUARTER 2010

Investment Objective

The Fat Prophets Australian Share Income Model Portfolio (the 'Model') aims to deliver a level of income in excess of that generated by the S&P/ASX200 Industrial Accumulation Index before taking into account Model fees and expenses.

Performance

Performance as at 30/09/2010	Gross	S&P/ASX 200 Industrial Accumulation Index	Outperformance*
1 Month	3.44%	3.81%	-0.37%
3 Months	7.01%	7.47%	-0.46%
6 Months	-3.54%	-4.57%	1.03 %
1 Year	-1.93%	-2.29%	0.36%
2 Year (%pa)	3.40%	3.00%	0.40%
Since Inception (% pa)^	-2.72%	-2.02%	-0.70%

*Shows the difference between Portfolio Gross Return and Benchmark Return

^Model Performance inception date 01/04/2008

Top 10 Stocks as at 30/09/10

1. Westpac Banking
2. Commonwealth Bank of Australia
3. ANZ Banking Group
4. National Australia Bank
5. Wesfarmers
6. Woolworths
7. Westfield Group
8. QBE Insurance
9. Suncorp-Metway
10. Transurban

Fund Managers Report

Dear Investor,

"The 19th century belonged to England, the 20th century belonged to the US, and the 21st century belongs to China. Invest accordingly" - Warren Buffett - September 2008

Quarter 3 2010 saw a very strong rebound in sentiment. Equity markets were clearly oversold at the beginning of the period as global macro risks in US, China and Europe coupled with a looming domestic election and company reporting season presented just too much uncertainty for investors. However, as the quarter progressed we did see several concerns abate;

- The Federal election concluded with no clear majority for either party. We see this as broadly positive for the market, as it reduces the likelihood of any major policy 'interference' over and above the proposed mining resource rent tax in the near future.
- The markets view of the global economic backdrop turned from negative to positive. A classic reversal of sentiment occurred as investors focused on what could go right rather than on what could go wrong. Many data points during the quarter showed marked improvement. In Europe we saw an uptick in service and manufacturing activity. PMI numbers were indicating accelerating recovery and a tumbling euro aided export growth over the period. Embattled UK banks resumed growth, with debt impairment levels falling faster than expected. In the US the economic data was broadly regarded as mixed. The US reporting season however illustrated that the level of pessimism was too high with most companies reporting profits which were approximately 12% ahead of consensus estimates. The recovery in earnings was very broadly based with even airlines and enfeebled car manufacturers making money.
- The local reporting season in August was really a tale of two halves. Revenue growth in industrial companies was much smaller than expected, growing 2% vs the previous corresponding period whilst for resource companies the number was just above 9% measured on the same basis. Industrial companies overall did reveal improving margins, driven in large part by a major focus on cost controls. The other standout feature was that corporate balance sheets are now laden with cash. This emanates from the fact that company boards continue to be conservative about the economic environment post the GFC when many of them raised capital and cut dividends. As a result, Australian listed companies are currently sitting on a record \$170bn of cash, equal to 13% of GDP. This leaves them very well positioned indeed to take advantage of business opportunities as they arise.

The corollary of our last point above is that we expect the merger and acquisition cycle to continue its already strong momentum and will be a dominant feature for equity markets, all other things being equal, over the next 12 months. This is being driven by a) lazy balance sheets and b) the fact that it remains cheaper to acquire growth via takeover or merger than to develop it from scratch and is a function of the current stage in the market cycle where equities overall are still cheap. Enterprise value to free cash flow ratios on the S&P 500 stand at 20x, which is at a ten year low. Looked at the other way around free cash flow yields now stand at a ten year high. Further underpinning this high level of activity is that the cost of corporate debt is very low. Hence many companies can raise long term debt finance below the above mentioned free cash flow yield of the target company they are acquiring.

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One area seeing a lot of M&A activity is the soft commodity space where BHP recently made a play for Potash Corp in Canada. Another significant example was the move by Canadian group Agrium Inc on AWB Limited. On one hand the high level of demand for commodities across the board is being driven by USD weakness, while on the other the current play on soft commodities also highlights the demographic shift in Asia, where a growing middle class is increasing the amount of protein in the local diet. We consider this as unlikely to change anytime soon.

Whilst we see clear value across the board in equities we have one concern in the short term. Pretty much everyone is now expecting the US Federal Reserve to at least maintain the size of its balance sheet and the matching trade of that is to short the USD and go long commodities. We have seen the size of short positions balloon over the last few weeks to an estimated \$30bn, an increase of 145% in two weeks. Hence, given that this is becoming a crowded trade, there could be an ugly break from the trend. We suspect however this will just be a short term phenomena which will be the result of profit taking. Our view on the underlying commodities complex has not changed one iota, we just see a lot more people starting to agree with a view that we have espoused for many years.

The threat of deflation is putting pressure on the US Federal Reserve to at least maintain the size of the Federal balance sheet. Many members of the Federal Open Market Committee (FOMC) voiced concerns about the Fed's now activated plan to re-invest maturing mortgage bonds into Treasury bonds, on the basis that they are not yet ready to embrace another round of asset purchases. However, a persistently weak labour market, weak housing market and the threat of deflation continues to provide some strong arguments for this policy given that 70% of US GDP relies on consumer spending and one of the key elements to maintain the health of the consumer is the housing market. Understandably, the average person in the street needs to see his/her negative equity move into positive territory before going out to spend more of their disposable income. Residential investment might be a fraction of US GDP but the health of the housing market is crucial to maintaining consumer confidence.

One headwind we are cognisant of for Australian businesses going forward is the rising AUD currency. The profit impact for companies with USD/Euro/Sterling earnings post a strong rally in the currency over the quarter could be material.

Notwithstanding the issues discussed we remain very positive about equity market performance heading into year end. After raising cash levels in April, we capitalised on the broad correction in the stock market and consequently our model portfolios are near to being fully reinvested. Whilst valuations overall remain undemanding, our economy is very much tied to Chinese growth. Its ability to manage a very steep growth trajectory will directly affect our own economy. Thus far its efforts to reign in credit growth have proved successful. China's transition to becoming less reliant on exports for its growth is in train and thus far gives us confidence. We believe it is therefore right to "Invest accordingly".

FAT PROPHETS AUSTRALIAN SHARE INCOME MODEL PORTFOLIO

Australian Share Income Model portfolio

Positive Influences			Negative Influences		
<i>Company</i>	<i>% Move</i>	<i>Position</i>	<i>Company</i>	<i>% Move</i>	<i>Position</i>
M2 Telecomm.	38%	Overweight	Incitec Pivot	31%	Underweight
Telstra	-20%	Underweight	Qantas	26%	Underweight
ANZ Bank	10%	Overweight	Leighton	15%	Underweight
Westpac	10%	Overweight	Intoll	43%	Underweight
APA Group	13%	Overweight	Brambles	15%	Underweight

During the period under review we moved to an underweight position in Telstra, reallocating these funds to M2 telecommunications. While the yield on Telstra is high and sustainable for the moment the visibility with regards to both structural separation and NBN remains clouded at best. As such we much prefer M2 Telecommunications (MTU), where we see clear value and excellent visibility and earnings momentum within the business model. Not only is MTU well placed to continue to make accretive acquisitions but it also has an unblemished record of integrating these businesses and leveraging the customer base of each of them.

Over the quarter Telstra slashed prices on several mobile and broadband products in an attempt to grab market share from rivals, namely TPG Group and Optus. MTU was unaffected as it is a reseller of both Telstra and Optus services so any cuts in price would be passed on to them as well. In addition, in September the ACCC handed down a proposal for indicative wholesale fixed line telecommunication service pricing for the period beginning in January 2011. The proposed 26% reductions in wholesale rental could provide significant cost savings for MTU in the second half of 2011. Unlike Telstra, the earnings potential for MTU is on the upside in our view.

Elsewhere, we increased our weighting in Macquarie Airports (MAP) as we see an enhanced value proposition in this stock. Not only has revenue growth continued, averaging approximately 6% pa but we continue to see operating leverage improve with margins at the EBITDA level now at 69%, representing a 3% improvement over the previous corresponding period. Sydney Airport, which is the flagship asset in its portfolio, is an extremely well managed asset. MAP is likely to benefit from higher traffic emanating from increased outbound tourism on the back of AUD strength. This has already been evidenced in September where traffic for the month was the highest on record, up almost 8% year on year. We expect this positive trend will likely continue over the coming quarter. MAP also paid a special distribution of 12.5 cents per security over the period prompted by the sale of their investment in a Mexican Airport Group (ASUR).

Over the quarter the model lagged its benchmark index by approximately 0.50%. This was largely due to our underweight position in Incitec Pivot, a highly volatile stock which rallied very strongly during the period. Other major detractors of performance are detailed in the above table. From a purely income standpoint the yield on the portfolio is estimated to be approximately 5.8% versus an index yield of around 5%. We are comfortable with our current bias toward financials and infrastructure. Moving forward we will look to focus on carefully selected smaller companies that meet our valuation and yield metrics such as M2 to provide more capital appreciation and further enhance the premium yield already being generated from the models investments.

Angus Geddes and Steve O'Hanna

Fat Prophets Fund Management Australia

FAT PROPHETS AUSTRALIAN SHARE INCOME MODEL PORTFOLIO

Model Portfolio name	Fat Prophets Australian Share Income
Code	FP0003
Model inception date	1/4/08
Principle investment objective	To invest in a sample of higher yielding securities taken from within and outside the S&P/ASX 200 Industrial Accumulation Index ('Index')
Can derivatives be used?	No
Indicative number of stocks	10-40
Minimum Model investment	\$20,000
Model Provider fees*	
Investment fee	0.45%
Performance fee applicable?	No
Benchmark Index	S&P/ASX 200 Industrial Accumulation Index

*Please refer to the Fat Prophets Separately Managed Account Product Disclosure Statement for further details

IMPORTANT INFORMATION

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