

FAT UPDATE

FAT PROPHETS MINING & RESOURCES MODEL PORTFOLIO – SEPTEMBER QUARTER 2010

Investment Objective

The Fat Prophets Mining & Resources Model Portfolio (the 'Model') seeks to outperform the total return (both income and capital growth) of the S&P/ASX 300 Resources Accumulation Index, before taking into account Model fees and expenses.

Performance

| Performance as at 30/09/2010 | Gross | S&P/ASX 300 Resources Accumulation Index | Outperformance* |
|---------------------------------|--------|---|-----------------|
| 1 Month | 7.88% | 7.03% | 0.85% |
| 3 Months | 10.29% | 10.25% | 0.04% |
| 6 Months | 3.85% | -1.94% | 5.79% |
| 1 Year | 12.39% | 8.72% | 3.67% |
| 2 Year (%pa) | 15.89% | 8.66% | 7.23% |
| 3 Year (%pa) | -0.40% | -2.86% | 2.46% |
| Since Inception (pa)^ | 7.45% | 4.64% | 2.81% |

*Shows the difference between Portfolio Gross Return and Benchmark Return

^Model Performance inception date 27/5/2007

Top 10 Stocks as at 30/09/10

1. BHP Billiton
2. Newcrest Mining
3. Rio Tinto
4. Woodside Petroleum
5. Catalpa Resources
6. Oil Search
7. Kingsgate Consolidated
8. Macarthur Coal
9. Eldorado Gold
10. Chalice Gold Mines

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

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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.

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".

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Mining and Resources Model Portfolio

| Positive Influences | | | Negative Influences | | |
|---------------------|---------------|-----------------|---------------------|---------------|-----------------|
| <i>Company</i> | <i>% Move</i> | <i>Position</i> | <i>Company</i> | <i>% Move</i> | <i>Position</i> |
| Catalpa | 24% | Overweight | Fortescue Metal | 26% | Underweight |
| Chalice | 64% | Overweight | Lynas Corp | 150% | Underweight |
| Azumah | 55% | Overweight | Equinox | 36% | Underweight |
| Kingsgate | 23% | Overweight | Rio Tinto | 15% | Underweight |
| Zambezi | 33% | Overweight | Sandfire Res. | 114% | Underweight |

Investor's focus on the commodities space continued in earnest in the latter part of the quarter. The speed at which we saw capital flow into commodities and commodity currencies (Canadian and Australian dollars) was surprising but it came as no surprise that the bulk of our performance came from gold names.

There were several changes to the portfolio over the period. The long held position in Andean was finally sold following the takeover move by Goldcorp. Andean appreciated approximately ten fold over the period held. Avoca was also removed from the model as a result of valuation and operational concerns. The resulting cash was used to add to the model a new holding in Azumah and increase our already overweight position in Newcrest.

Amongst the global majors, Newcrest has one of the most impressive growth profiles. We believe the Company is on track to achieve volume growth of 0.9m ozs of gold production, translating to a 100% growth in earnings per share over the next four years. Azumah is an emerging gold producer in Ghana, West Africa. Having experienced some difficulty finding value amongst the producers, we have very selectively moved 'downstream' into the emerging space. Azumah met all of our search criteria. Ghana has a long history of mining with many 10m oz plus gold discoveries and the presence of most of the gold majors, including Newmont, Goldfields and Newcrest. Azumah has a 1.1m oz non-refractory gold resource which has been delineated on a fraction of an identified strike 150km long. A low enterprise value per oz was attractive relative to a purchase entry price of just 40cents, which stood out relative to its peers. In addition, after meeting with the company's management we believe Azumah has a very significant opportunity to expand its resource well beyond current levels.

The other addition to the portfolio was Zambezi Resources (ZRL). ZRL is an emerging copper focused explorer that has recently been recapitalised on the back of several very prospective assets in the Zambian Copper belt. Zambia is the largest producer of copper in Africa. As mentioned in our previous quarterly, copper is our favourite base metal. Over the last quarter the copper price has firmed some 30% to approximately \$3.80 per lb. Having been offered the stock in a broker placement at 1.8 cents we were able to take a 1% position at what we believe is an attractive price. In June ZRL announced a 20mt JORC compliant resource at a grade of 0.90%, resulting in 194k tonnes of contained metal. In addition to this resource, known as Kangaluwi, there is a neighbouring deposit called Cheowa, which sits in a JV with Glencore and contains a JORC resource of 6.5mt at 1.13% copper. The deposit contains in excess of \$1bn of in situ value, which is very significant for a company with a market capitalisation of just \$26m.

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Additionally, Zambezi has some 2000 assay results still to be released, which could potentially increase the resource further. In order to generate early cash flow Zambezi is evaluating reprocessing copper waste dumps. Early assessment has found that only one of the initial three dumps tested are economic so the company is looking to secure the rights to assess further rock dumps at Chingola. Equinox, a \$4bn Australian listed copper producer that mines copper from the same mineralised belt where ZRL's assets are located provides some indication of the potential upside.

Looking ahead, the portfolio continues to maintain an overweight position in gold and precious metals. We believe the bull market in precious metals has a long way still to run and will therefore continue to look for opportunities as prospective as the companies detailed above. Although only marginally ahead of the benchmark index for the quarter over the last 6 months there has been significant value added of almost 6%. We remain committed to adding further value in the months ahead.

Angus Geddes and Steve O'Hanna

Fat Prophets Fund Management Australia

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| | |
|---------------------------------------|--|
| Model Portfolio name | Fat Prophets Mining & Resources Share |
| Code | FP0002 |
| Model inception date | 25/5/07 |
| Principle investment objective | To invest in a sample of mining and resources securities listed on the ASX |
| Can derivatives be used? | No |
| Indicative number of stocks | 10-40 |
| Minimum Model investment | \$20,000 |
| Model Provider fees* | |
| Investment fee | 0.75% |
| Performance fee applicable? | Yes |
| Brief description | 10% of any outperformance of the benchmark index |
| Benchmark Index | S&P/ASX 300 Resources Accumulation Index |

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

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