

FAT UPDATE

FAT PROPHETS AUSTRALIAN SHARE INCOME MODEL PORTFOLIO – JUNE 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 30/06/2010	Gross	S&P/ASX 200 Industrial Accumulation Index	Outperformance*
1 Month	-2.52%	-3.17%	0.65%
3 Months	-9.87%	-11.20%	1.33%
6 Months	-8.91%	-9.93%	1.02%
1 Year	15.70%	14.62%	1.08%
2 Year (%pa)	-0.66%	-0.90%	0.24%
Since Inception (% pa)^	-5.90%	-5.32%	-0.57%

*Shows the difference between Portfolio Gross Return and Benchmark Return

^Model Performance inception date 01/04/2008

Top 10 Stocks as at 30/06/10

1. Westpac Banking
2. Commonwealth Bank of Australia
3. ANZ Banking Group
4. National Australia Bank
5. Woolworths
6. Telstra Corporation
7. Westfield Group
8. Wesfarmers
9. Westpac Office Trust
10. QBE Insurance

Fund Managers Report

Dear Investor,

Equity markets over the last quarter were best described as nervous and volatile with the convergence of a number of headwinds creating the 'perfect storm' for equity markets.

Consider the following;

- A European debt crisis saw sovereign risks increase sharply, firstly with Greece being downgraded and subsequently subjected to a €750bn rescue plan by the EU. Then rating agency Fitch downgraded Spain - a far more significant member of the Euro-zone.
- The Euro hitting a four year low versus the USD, having declined circa 14% to end June.
- Fears regarding the strength of the recovery in the US, as reflected in recent sluggish US payroll numbers and other economic data. Private sector jobs growth has yet to ramp up and the prospect of stimulus fade weighed heavily on investors' minds.
- Chinese economic data also exhibited signs of slowing, largely as a result of tighter credit controls on banks, leading the markets to readjust GDP growth closer to 10% than the previous expectation of as much as 14%, albeit still a very strong number.
- Commodity prices also fell sharply, especially base metals, which have declined between 12-20% peak to trough over the period.
- The proposed introduction of RSPT on the mining industry cast a pall over the sector and the AUD fell sharply as uncertainty over the implications for valuations prompted foreign investors to flee with the AUD falling 11% in less than a week. Timing of this proposal certainly did not help.

The end result was that the ASX 200 sank just over 11% over the period and the combined effect of these events meant that risk aversion reached extreme levels. However, there was some relief towards the end of the quarter as foreign exchange markets stabilised and the disastrous RSPT was withdrawn and replaced with a more palatable alternative. With the Australian dollar rebounding resource stocks outperformed their industrial counterparts by a margin of more than 2% in June.

The banks were hardest hit, falling 5% over the closing weeks of the quarter, on concerns about rising wholesale funding costs, which in some part offset the benefit of improving debt impairment levels. Looking forward, we are increasingly of the view that returns for banks will be modest when compared to the stellar returns of 2009 as bank returns tend to be strongly correlated to credit growth and we struggle to see how households can increase their debt levels further at this point in the interest rate cycle.

In the run up to the end of the review period investor attention did return once more to Europe, with rising fears of 'deflation' surfacing over the recent introductions of fiscal austerity measures and the resulting negative economic impact of tightening expenditure prematurely before the recovery in the Eurozone gains traction. The fear being that the world would maybe witness similar historic parallels with the 1930s when following the 1929 crash the authorities reigned in spending early, balanced budgets and increased interest rates. This had the effect of stifling the recovery and was one of the factors that caused the Great Depression. We believe that these fears are being somewhat overplayed at present. With too much pessimism and negative rhetoric having emerged in recent weeks this leads us to believe that the lows for this particular correction were set in June.

Whilst real risks do remain for the global recovery, it would appear that both equity and bond markets have adequately discounted these dangers for the time being. Bonds are pricing in a severe recession and possibly the onset of deflation in the US with 2 year Treasury yields at around 0.6% and the 10 year at around 2.9%. Markets appear to be signalling not only nil expectation for rates to rise in the US anytime soon but moreover, little in the way of economic growth. With risk aversion back on the table, investors seem to be clearly more concerned about return of capital than return on capital!

However, in our view Australian equities presently represent good relative value. Historically, a yield gap between bonds and equities at levels of less than 400 basis points has tended to be a bullish indicator for stocks. In March of 2003 this gap had shrunk to around 150 basis points and in the 3 years that followed the All Ordinaries Index rallied more than 60% excluding dividends. Current spreads are now below that level, giving what appears to us to be a clear relative value signal that at the very least equity markets are oversold.

Although forex markets have stabilised, we continue to believe the US dollar will come under further sustained pressure, with significant structural headwinds lying ahead for the currency. The economic numbers are staggering when one considers that the \$3.5 trillion of Obama administration spending over the last 12 months accounts for one in four dollars of US GDP over the same period. Even more worrisome is total spending exceeds the Federal Government tax take of \$2.1 trillion by a massive \$1.4 trillion. At the State level, California has 12% unemployment and a budget gap of \$US19bn, which is far greater than Greece, Portugal, Ireland, Hungary and Romania combined!

The US Government faces a difficult time ahead, balancing economic recovery (and the ongoing threat of deflation) against rising debt levels and the attendant growing risks for the US dollar. Fortunately, there now appears to be a genuine resolve amongst US lawmakers to tackle the debt problem in the US, however it will require much political will and bi-partisanship to bring current spending (and future spending obligations) under control.

Despite a growing chorus calling a double dip recession in the US history suggests that it would take a substantial shock to bring about the second leg of economic contraction. One obvious cushion is provided by strengthening US corporate balance sheets, which are increasingly able to support investment growth as confidence in the economy rebuilds. The US reporting season has been quite robust and underpins our thinking that notwithstanding the very significant public debt issues in the US the economic recovery is intact. Second quarter earnings expectations were 12% ahead of pre-reporting consensus. Importantly profit growth in 2Q10 was stronger compared to both 2Q09 (+53%) and 1Q10 (+17%). Earnings growth expectations for the S&P500 in the 3Q2010 are in the double digits. Our own reporting season is looking equally robust. What also gives us confidence that the recovery is underway is that we are seeing a pick-up in M&A activity globally. Locally we have seen a raft of activity, particularly in the coal sector. This is now moving into the soft commodity space with AWB/Agrium and, what is likely to be biggest one of the year, BHP/Potash Corp.

The absence of a clear majority win by either major party in the federal election over the weekend is a clear negative for Australian equities. A lack of policy direction on a raft of reforms will increase the level of uncertainty for the foreseeable future. Regardless of whichever political party do manage to form government it will be a minority one and therefore somewhat ineffective versus an absolute majority. One of the major issues is the Minerals Resource Rent tax which now clearly hangs in the balance. Notwithstanding this, given the overall positive tone of reporting season, we expect equities to start finding more positive traction looking ahead to the second half of 2010, especially in light of compelling valuations and an improving global backdrop.

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>
Brambles	-26%	Underweight	*Transfield Inf.	-14%	Overweight
Westpac Office	8%	Overweight	Westpac Bank	-24%	Overweight
Westfield	1%	Overweight	Coca Cola Am.	6%	Underweight
APA Group	1%	Overweight	Ardent Leisure	-28%	Overweight
GPT Group	-2%	Overweight	Amcor	0%	Underweight

* Decline in share price since purchase.

The investment landscape for income yield focused investors has altered significantly post the GFC. Traditionally a large part of any income driven portfolio would have been the Real Estate Investment sector or REITs. However, long suffering shareholders in this space have been diluted virtually out of existence as a result of debt laden balance sheets being refinanced with equity at rock bottom prices. Three years on they have moved to simpler capital structures with much lower debt levels. As a result their risk profiles have changed. Unfortunately their yields are lower now than pre the GFC as a result of this more conservative balance sheet management.

We cashed out of Westpac Office Trust as a result of takeover by the Mirvac Group. We expect more corporate activity in this space as asset values improve, particularly in North America where many trusts have retail and office assets. The discounts to NTA are in some cases excessive and will be highly earnings accretive targets for those with more expensive scrip. The sector has traditionally traded at a 3% premium to NTA but at present trades at a 24% discount. We are therefore scouring for more opportunities in this space.

One addition over the period was Transfield Services Infrastructure Fund (TSI). The fund is a portfolio of wind generation assets, coal power stations and water filtration plants. These tend to provide predictable and stable cash flows. They have recently undertaken a capital restructure which is what drew our interest. Central to the restructure was the equitisation of some debt. Subsequently the distribution was re-set at a level that is sustainable over the medium term and, critically, is paid out of operating cash flow after maintenance capex and the servicing of debt and not funded from debt, as many such infrastructure funds have been. At our entry price the yield was approximately 12%, the valuation sensible and the assets of high quality.

Elsewhere in the portfolio we added Woolworths. Its share price was recently sold down as evidence of a resurgent Coles revealed that its turnaround is on track and is a growing threat to Woolworths. We believe that Woolworths was oversold and as a result the yield premium to market looked compelling enough to close our underweight position here.

We will continue to focus on high quality above market yield opportunities where we see yields as not only sustainable but growing.

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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