

FAT UPDATE

FAT PROPHETS CONCENTRATED AUSTRALIAN SHARE MODEL PORTFOLIO – JUNE QUARTER 2010

Investment Objective

The Fat Prophets Concentrated Australian Share Model Portfolio (the 'Model') seeks to outperform the total return (both income and capital growth) of the S&P/ASX 200 Accumulation Index, before taking into account Model fees and expenses.

Performance

Performance as at 30/06/2010	Gross	S&P/ASX 200 Accumulation Index	Outperformance*
1 Month	-1.26%	-2.59%	1.32%
3 Months	-8.13%	-11.14%	3.01%
6 Months	-7.42%	-9.93%	2.51%
1 Year	14.53%	13.15%	1.38%
2 Year (%pa)	-4.49%	-4.94%	0.45%
3 Year (%pa)	-3.76%	-7.85%	4.09%
Since Inception (%pa)^	-2.60%	-7.70%	5.10%

*Shows the difference between Portfolio Gross Return and Benchmark Return

^Model Performance inception date 31/5/2007

Top 10 Stocks as at 30/06/10

1. BHP Billiton
2. ANZ Banking Group
3. Newcrest Mining
4. National Australia Bank
5. Westpac Banking
6. Commonwealth Bank of Australia
7. Lihir Gold
8. Oil Search
9. Woodside Petroleum
10. Rio Tinto

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.

Concentrated Australian Share Model Portfolio

Positive Influences			Negative Influences		
<i>Company</i>	<i>% Move</i>	<i>Position</i>	<i>Company</i>	<i>% Move</i>	<i>Position</i>
Lihir Gold	+42%	Overweight	Woolworths	-4%	Underweight
Newcrest	+7%	Overweight	Sonic Health	-27%	Overweight
Catalpa	+7%	Overweight	C C Amatil	6%	Underweight
Coeur D'Alene	+18%	Overweight	Amcor	unch.	Underweight
Ramsay Health.	+1%	Overweight	Graincorp	-14%	Overweight

The portfolio has maintained a very defensive bias over the period which has benefited performance with the fund beating its benchmark by just over 3.0%. Much of the positive performance was attributable to the funds large position in select gold names as seen in the table above. Amidst the turmoil in the markets the gold price rallied 20% in AUUSD terms in sharp contrast to the 11% fall in equities. In the three months to end June there were a number of additions to the fund as we looked to reinvest the large cash position in shares offering what we saw as compelling value. Such recent additions to the portfolio included Magellan Financial Group, M2 Communications and Austar United Communications.

Magellan Financial Group is an emerging fund manager that specialises in both international equities and infrastructure investments. Still largely under the radar of the broader investment community its profile is growing as a result of its exceptional performance and growing funds under management (FUM). FUM have grown from approx \$600m at the beginning of this calendar year to currently \$1.15bn. Given the calibre of management coupled with consistent top quartile performance, our expectation is for their growth rate to remain very robust.

M2 Communications is a telco that resells a broad range of fixed line, mobile and data products from Telstra, Optus and Vodafone. We respect the track record of this company. M2 has been highly acquisitive over the last few years and very importantly has demonstrated the ability to integrate these successfully. Meaningful value accretion results when a public company such as M2 is trading on 6-7x ebitda and acquires private companies trading on half that multiple. M2 has also improved margins over the last few years in a meaningful way. This is largely accomplished with scale, as with any company with a fixed cost base, however as they grow their bargaining position with Telstra and Optus also improves. Finally, it has a compelling valuation and a healthy yield of around 7%.

Austar is a subscription television provider. It's virtually a monopoly subscription television service in regional and rural Australia. We believe there is much more growth to come with this business, which in our opinion is not reflected in the price. Operating profit growth has been outstanding over virtually any period examined and importantly is growing at virtually twice the rate of programming expense growth. Subscriber growth as recently reported was subdued reflecting a soft retail environment; however revenue per subscriber grew over 5%. Austar therefore delivered increased content to each subscriber which highlights the quality of their offering continues to improve.

Angus Geddes and Steve O'Hanna

Fat Prophets Fund Management Australia

FAT PROPHETS CONCENTRATED AUSTRALIAN SHARE MODEL PORTFOLIO

Model Portfolio name	Fat Prophets Concentrated Australian Share
Code	FP0001
Model inception date	31/5/07
Principle investment objective	To invest in a small sample of securities taken from within and outside the S&P/ASX 200 Accumulation Index ('Index')
Can derivatives be used?	No
Indicative number of stocks	10-30
Minimum Model investment	\$20,000
Model Provider fees*	
Investment fee	0.50%
Performance fee applicable?	Yes
Brief description	15% of any outperformance of the benchmark index
Benchmark Index	S&P/ASX 200 Accumulation Index

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

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