

## FAT UPDATE

## Investment Manager's Insight

## December Review 2011

Don't wait for the robins to appear

With 2011 now clearly in the rear vision mirror, it was without a doubt a very challenging year for equity markets. The key ASX 200 index was down 10.5% for the year and December was a down month, losing 1.5% on the same measure. The number of hurdles the market faced in 2010 was phenomenal, not just in terms of economic crisis but also in terms of natural disasters here ( Qld floods) and overseas, most notably being the Japanese tsunami, earthquake and nuclear disaster.

In the absence of further challenges on the environmental front, economically, we start the year being quite optimistic. What has come to light over the last few weeks is the strength of the US recovery. This data continues to impress, with the latest employment and manufacturing numbers reaffirming our view that the nascent recovery is gathering pace. Jobless claims trend is clear, from 600k per month in early 2009 to 380k currently. Manufacturing is in expansion mode as well, a weaker US dollar certainly helping on this front.

In Europe, one new development really caught our eye and that is how the European Central Bank (ECB), is providing liquidity to the Euro zone's banks. The ability to borrow from the ECB at rates near 1% and to own sovereign debts earning 5-7% shall do much to restore health to Europe's banks. In addition, the quality of the collateral required to participate in this scheme was lowered. This is significant as it is almost identical to the measures undertaken by Federal Reserve in the US at the height of the GFC.

These actions will also underpin our large position in gold equities, as gold should benefit from central banks collectively engaging in quantitative easing and debt monetisation initiatives. As Europe navigates its way through the debt crisis, confidence will grow in markets. The record amount of liquidity parked in cash and bonds on the sidelines can expect to flood back into equities at some point. We are of the view that most indices will rally by 15% to 20% this year. There is therefore upside risk in the market and those waiting for the robins to appear could miss out on Spring.

**Fat Prophets Concentrated Australian Share – Model Portfolio**

Positive Influences			Negative Influences		
Company	% Move	Position	Company	% Move	Position
Maryb. Sugar	+44%	Overweight	Linc Energy	-42%	Overweight
Magellan Finance	+20%	Overweight	UXC	-20%	Overweight
Oil Search	+10%	Overweight	Gold Road	-21%	Overweight
Silverlake	+17%	Overweight	Newcrest	-13%	Overweight
Graincorp	+12%	Overweight	M2 Telecomm	-6%	Overweight

Over the course of the month, we added to our existing holdings in IOOF and Telstra. IOOF is a wealth manager that has been successfully pursuing an acquisition strategy for a number of years. It's most significant acquisition being Australian Wealth Management, which had funds under administration of \$11bn at the time of purchase. Its ability to extract costs/achieve synergies has been the key to its success. Its current simplification strategy still offers plenty of upside.

Elsewhere, Telstra's 7.5% 'sustainable yield' and circa 11x PE remains attractive value at these levels, and in our view downside risk is far outweighed by the upside. We recently met with Telstra and we were reassured with the company's corporate strategy. The NBN frees capital for Telstra that would otherwise be trapped in a decaying asset. Over the last 12 months we have seen the regulatory risk slowly diminish and the share price re-rated. The NBN deal is now on the cusp of approval by the ACCC. This is the final regulatory hurdle for Telstra for completion of this deal to commence receiving \$11bn in payments for its legacy network.

Operationally, Telstra has made headway in mobiles and broadband and remain in a market leading position in terms of product position and network quality. The re-rating we have seen has further to run in our view, along with continued outperformance against the broader market.

## Fat Prophets Mining and Resources – Model Portfolio

Positive Influences			Negative Influences		
Company	% Move	Position	Company	% Move	Position
Cape Lambert	+26%	Overweight	Linc Energy	-42%	Overweight
Orocobre	+14%	Overweight	Santos	8%	Underweight
Oil Search	+10%	Overweight	Gold Road	-21%	Overweight
Silverlake	+17%	Overweight	Zambezi	-20%	Overweight
Bluescope Steel	-33%	Underweight	Kingsgate	-21%	Overweight

The major change was a switch out of Kingsgate and into Medusa. Kingsgate has been disappointing since its acquisition of Dominion Mining. The Challenger asset of dominion mining we believe will live up to its name! Meanwhile, Medusa is a gold miner in the Philippines. It is a low cost (circa USD200 per oz cash cost) high grade producer (10g/t Au average recovered grade in 2011). It is set to produce 90-100k oz in 2012 and double that by 2014 with a 5 year goal of 400k oz per annum. Given that 2011 production was double 2009, there is a reassuring track record here. What drew our attention to it was its precipitous share price fall over the last 4 months of 2011 from over \$8 to around \$4.50 which is where our purchase was made and a level we consider value. The catalyst for the selloff was news of a tropical storm which did damage a haul road and is likely to have a small negative impact on production in the thousands of ounces. A 45% decline on the back of this is clearly overdone in our view.

## Fat Prophets Australian Share Income – Model Portfolio

Positive Influences			Negative Influences		
Company	% Move	Position	Company	% Move	Position
Aust. Pipeline	+11%	Overweight	M2 Telecomm	-6%	Overweight
Fletcher Buidling	-23%	Underweight	Newscorp	10%	Underweight
Resmed	-16%	Overweight	Wesfarmers	-7%	Overweight
Duet	8%	Overweight	Brambles	11%	Underweight
Myer	-6%	Underweight	CSL Ltd	8%	Underweight

There were no changes to the portfolio over the period. There was a restructure in the funds holding in Macquarie Airports (now Sydney Airport) which has simplified its corporate structure. The restructure included an asset swap of its interest in two European airports (Copenhagen and Brussels) for an increased stake in Sydney airport. The result of which was a large capital return in addition to an unfranked dividend which totalled 90 cents per share. The stock has held up relative to the market providing a 6% return for the year versus a 10% decline in the overall market in 2011.

Infrastructure stocks have been a key focus for this portfolio and will continue to be so; APA has been our largest single position in the infrastructure /utility space and has seen its share price up 7% over the course of 2011 in addition to paying a 10% dividend yield.

## **Angus Geddes and Steve O'Hanna**

### **Fat Prophets Fund Management Australia**

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