

FAT UPDATE

FAT PROPHETS CONCENTRATED AUSTRALIAN SHARE MODEL PORTFOLIO – DECEMBER QUARTER 2009

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 31/12/09	Gross	S&P/ASX 200 Accumulation Index	Outperformance*
1 Month	2.77%	3.74%	-0.97%
3 Months	4.37%	3.39%	0.98%
6 Months	23.71%	25.62%	-1.91%
1 Year	39.32%	37.03%	2.29%
2 Year (% pa)	-4.60%	-8.16%	3.56%
Since Inception (% p.a)^	-0.15%	-5.36%	5.21%

*Shows the difference between Portfolio Gross Return and Benchmark Return

^Model Performance inception date 31/5/2007

Top 10 Stocks as at 31/12/09

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

Fund Managers Report

2009 will go down in history as one of the most tumultuous years for financial markets with the recovery rally in equity indices off the March lows through to calendar year end proving spectacular by pretty much any measure. Financials, which were 'ground zero' of the global financial crisis, led the way up with the local four major banks all posting substantial gains. That Australian banks now account for four of only eight banks globally rated AA, is testament to the high quality and resilience of their underlying businesses when compared to many of the more aggressive banks offshore, particularly those in the US and Europe. This has attracted foreign investment onto the share registers of the Australian banks. We continue to expect the favourable competitive environment for banks will likely continue in 2010. Domestic competition has been reduced by the GFC and the bad debt cycle has reached a turning point.

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Renewed investor interest within the resources sector throughout the fourth quarter was also instrumental in driving the Resources Index up 42%, leaving it well ahead of the broader index.

In the period under review the Concentrated Australian Share model outperformed its benchmark by just under 1% with a gain of 4.37% against the rise of 3.39% recorded by the ASX 200 accumulation index.

Having made much of the running earlier in the year banks took a back seat to the resources sector in the last quarter as improved economic activity translated into higher commodity prices virtually across the board. There was particular strength in bulk commodity prices such as iron ore and coal so the model benefited from overweight positions in Macarthur Coal and Rio Tinto. In the case of the latter more than 60% of earnings come from iron ore, the contract price for which could well be set 30-40% above last year's level.

The other two main contributors to performance over the quarter were the funds overweight positions in Incitec Pivot and AXA Asia Pacific. Incitec Pivot is a world class business with two main divisions focussed on the manufacture of fertiliser and explosives. Both products have the same key inputs and hence are complimentary from a manufacturing perspective. Incitec Pivot has been benefiting from a much improved outlook in commodity markets, where more capital is being deployed in exploration and also in expansion of existing mineral resource projects - these all require explosives. At the same time fertiliser prices are also trending up following a difficult 2009. Most producers worldwide are operating at close to effective capacity, and the upturn in foreseen demand is expected to lead to higher average prices for nitrogen and phosphates in 2010. This coupled with Incitec's production capacity, which has tripled in the last 4 years, illustrates how much leverage there is to improved prices.

AXA also made a strong contribution to performance with the company currently subject to a takeover tussle between AMP and the National Australia Bank. It is our view that AMP has the greatest synergies to gain from acquiring the domestic AXA business. We will continue to hold and follow the takeover battle with interest.

The main change to the model during the quarter was the introduction of exposure to the healthcare sector via the addition of Ramsey Health Care and Sonic Healthcare on the basis of that both companies are very well positioned to benefit from the developed world's rapidly aging demographic coupled with attractive share valuations given an expected industry growth rate of circa 15% p.a.

As to the immediate outlook, the economic recovery appears to be gaining traction both here and abroad. In the US many indicators have improved markedly, however it is yet to be seen whether these will be sufficient to result in meaningful employment growth, despite manufacturing, which accounts for about 12 percent of the US economy and a key driver of the recovery, likely to continue expanding. Despite the improving economic performance indicators, we believe there remains a risk of a "double dip recession" in the U.S this year.

We see tightening monetary policy in China and related measures such as lifting bank capital ratios as a stabilising influence and therefore extremely positive over the longer term. We have all collectively experienced firsthand over the past 2 years, the dangers of Central Banks keeping monetary policy settings too loose for too long.

Chinese credit growth on the back of massive stimulus has seen domestic asset prices rise steeply and thus become unstable. We don't have to point out that asset price bubbles are potentially very dangerous and we all know what happened in the US with lax regulation around residential mortgages. China is attempting to control the quality of loans as well as quantity, which is very encouraging. Equally, we have also been heartened by the actions of the RBA, one of the few central banks in the world to actually increase interest rates to counter the effects of stimulus.

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We continue to believe the gold sector offers value having underperformed relative to the gold price. The latest concerns over Greece and other countries in Europe are very real in our opinion, with current account deficits rising to an alarming proportion of GDP. Sovereign risk is likely to continue rising this year as some countries have to continue rapidly borrowing to fund stimulus efforts. It is probable in our view the balance sheets of central banks will continue to expand over the medium term with the ongoing attempts to reflate. This will have a negative impact at some point on bond valuations, and we see interest rates rising as the market prices in a greater risk premium and also the potential for future inflation. Gold should do well in this environment.

Overall, we believe the global economy will gather momentum in 2010. Not only will the unprecedented mix of near-zero interest rates and high budget deficits engineer an economic recovery that is real and sustainable but the strong bounce already seen in economic activity across much of Asia will help to offset the inevitable deleveraging within developed economies such as the US and UK. Asian economies and countries such as Brazil, India and China (and Australia) will therefore likely outperform Europe and the US for quite some time.

We aren't expecting a swift return to robust growth (as alluded to above regarding US unemployment). In fact, the recovery will likely lag behind those of previous recessions, but we believe that the world economy will perform far better than the economic consensus would indicate. The benefit of lax policy settings and other direct measures such as quantitative easing have yet to fully impact on the global economy.

Domestically, the bulk of the Rudd governments deficits are also still to be felt as only a portion were in the form of cash handouts. Hence we expect local growth to be strong, this is however against a backdrop which will likely exhibit the following challenges;

- Rising interest rates - November retail sales numbers were four times consensus and will likely put upward pressure on rates in addition to strong employment numbers
- Overheating Chinese economy- the property market has risen 57% over the course of 2009 and will be subject to continuous Government intervention to engineer a slowdown
- Capacity constraints - due to long lead times to expand infrastructure such as ports, processing plants etc
- Rising Australian dollar - a potential headwind for the resources space and other exporters.

Corporate balance sheets have undergone a significant amount of repair over the last 12 months, with gearing reduced back toward long term averages. Earnings per share growth will be hampered by all the additional shares on issue as debt has been switched to equity. ASX listed companies raised a record \$100bn in new equity in 2009. Notwithstanding these challenges, on balance we remain optimistic that equities will deliver in 2010, albeit in a challenging environment.

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

IMPORTANT INFORMATION

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