

### Portfolio Performance

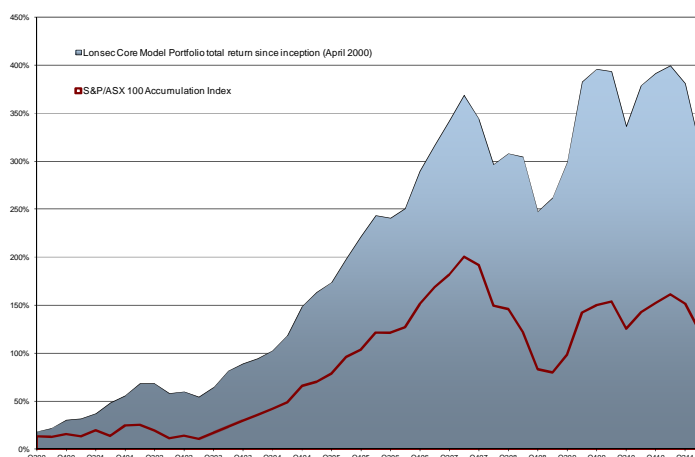
INVESTMENT PERFORMANCE											Since	Since
Period ending	30 September 2011	Month	Qtr	Year	2 Yrs <sup>1</sup>	3 Yrs <sup>1</sup>	4 Yrs <sup>1</sup>	5 Yrs <sup>1</sup>	7 Yrs <sup>1</sup>	10 Yrs <sup>1</sup>	Inception <sup>1</sup>	Inception <sup>2</sup>
<b>Lonsec Core Model Total Return<sup>3</sup> (%)</b>		<b>-7.1</b>	<b>-13.6</b>	<b>-13.2</b>	<b>-7.2</b>	<b>0.9</b>	<b>-3.0</b>	<b>3.4</b>	<b>9.6</b>	<b>10.9</b>	<b>13.2</b>	<b>315.7</b>
S&P/ASX 100 Accumulation Index (%)		-5.8	-11.6	-8.3	-4.2	0.1	-7.3	-0.4	5.9	6.9	7.2	122.5
Excess return (%)		-1.3	-2.0	-4.9	-3.0	0.8	4.3	3.8	3.7	4.0	6.0	193.2
Portfolio excess return (alpha) since inception (% p.a.)		6.0		Portfolio volatility since inception (%)		14.6						
Portfolio tracking error since inception		6.9		Benchmark volatility since inception (%)		14.8						

<sup>1</sup> % per annum <sup>2</sup> Total return since inception date 17 April 2000

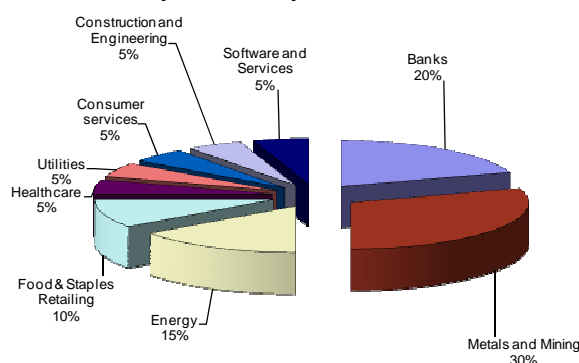
<sup>3</sup> Investment performance includes dividends (but not franking credits) and is calculated before fees, brokerage and taxes. Past performance is not a reliable indicator of future performance.

The Core model portfolio is a fully invested model portfolio that is re-balanced every six months (31 March and 30 Sept) back to the model portfolio target weights.

Physical portfolio results will differ depending on cash levels, start date, brokerage, fees, taxes and re-balancing policy.



### Core Portfolio by GICS Industry



### Portfolio Objective

To deliver strong returns above benchmark, over the medium to long term, by investing in a concentrated portfolio of large-cap Australian listed companies.

Suitable for investors seeking capital growth and a good dividend yield over a holding period of at least 3 years.

### Portfolio Profile

<b>Investment philosophy:</b>	Top-down, quality at a reasonable price, high conviction, low turnover
<b>Investment universe:</b>	ASX 150 stocks excluding A-REITs
<b>Benchmark:</b>	S&P/ASX 100 Accumulation Index
<b>Inception date:</b>	17 April 2000
<b>Min/Max no. of stocks:</b>	12 – 20
<b>Typical no. of stocks:</b>	15
<b>Minimum no. of GICS Industries:</b>	8
<b>Stock rules:</b>	Maximum stock target weight 15%
	Stocks weighted at 10% or more must be selected from ASX 50
	At least 80% of the portfolio must be invested in ASX 100
<b>Current market-cap weightings:</b>	ASX 50                      90%
	ASX 51-150                10%
<b>Current portfolio dividend yield:</b>	4.3% (83% franked)
<b>Average turnover:</b>	20-30% p.a.

### Portfolio commentary

*Note: Portfolio and stock commentary is the view of Lonsec's model portfolio team and may occasionally differ from company research published by Lonsec stockbroking.*

September was a very frustrating month. At the start of the month, we made a move to increase our defensive holdings with WOW increased to 10%. This move paid off immediately given the market was down 5.8% while WOW managed to rally 1.2%. However, a shock implant recall notice by Cochlear (the first ever) led to a major de-rating in COH's share price with the stock down 39% by the end of the month. After careful consideration of all information available at the time, we elected to remove COH (it was removed on 15 September 2011 at \$50.30/share) and replace it with ANN. While a fall from above \$70/share to around \$50/share could seem to be a buying opportunity, we are concerned that COH's premium PE rating will shrink from 22 times earnings to somewhere around 15-16x (similar to CSL) because the market is now aware that the business has more risk than first thought. If we are correct, COH is overvalued above \$50/share and should eventually settle into a \$42-48/share trading range. For more information on COH and ANN, please see the most recent *Core Model Portfolio Change* document.

The bottom line is that the portfolio underperformed by 1.3% in September and is now 4.9% below benchmark on the rolling year and 3.0% below benchmark over the past two years. While it would be an understatement to say that we are disappointed with recent performance we remain quite confident in the portfolio for two reasons: Firstly, we know that some of the stocks have been underperforming for short term reasons. For instance, ORG and WPL have been held back by their capital-intensive growth plans which will soon bear fruit. Secondly, given the concentrated nature of the portfolio, performance can improve quite rapidly when just a few stocks rally. We have seen this with the Income portfolio which moved from underperforming by -4.7% (on the rolling year to April 2010) to outperforming by 6.2%, within a quarter. And since then the Income portfolio has maintained strong outperformance. That said, we continue to monitor and review the top-down themes and the bottom-up fundamentals of each stock in the portfolio. We don't like to make changes but the global and domestic environment is constantly changing and we need to constantly reassess whether we have the optimal portfolio positioning for the current outlook. If we don't feel we do, we will make a change, when the timing is right. For these reasons, we encourage all clients to maintain their direct growth portfolios as close to the Core portfolio as possible.

#### William Keenan

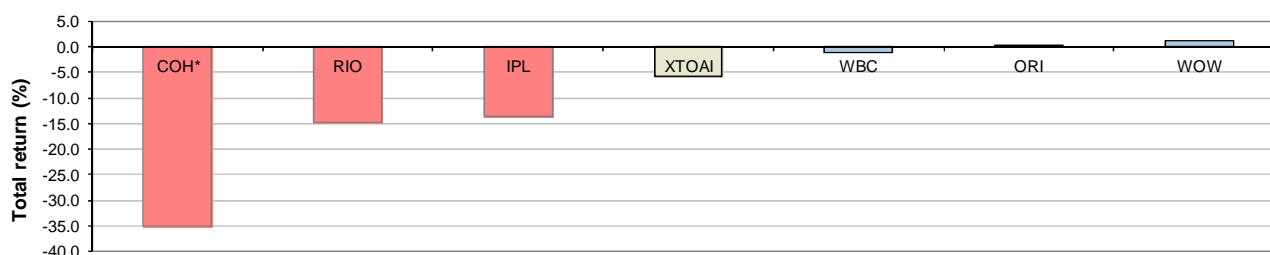
Senior Equity Strategist

#### Did you know?

Lonsec's model portfolio team releases regular email research notes on model portfolio stocks (based on material events) to all clients of Lonsec stockbroking and portfolio services. Recent updates include: FGL takeover take III, Core model portfolio changes 1 and 15 September 2011, RIO, COH, AGK updates, MMS FY11 result, IRE 1H11 result and MTU FY11 result.

### Stock performance and commentary

Major underperformers and outperformers - September 2011



\*COH was removed from the portfolio on 15 September 2011 at \$50.30/share.

**WOW (+1.2%)** held steady as investors flocked to defensive stocks. In Lonsec's view, WOW is the most defensive stock in the ASX 50 given 91% of EBIT is generated from Food, Liquor and Petrol and it has low regulatory, AUD and debt risk.

In the short term, WOW is likely to generate single-digit earnings growth as retail conditions are soft and the rollout of Masters home improvement warehouses will generate small losses in the short term. Over the medium term, retail conditions should improve as the market expects interest rate cuts during FY12. In addition, Masters should provide an important new source of sales and profit growth over time.

The market (analyst consensus) forecasts WOW to generate a FY12 NPAT of \$2.2bn, equivalent to EPS of \$1.80 and DPS of \$1.30. On that basis, WOW trades on a FY12 PER of 13.6x and a dividend yield of 5.3% ff. In volatile market conditions, WOW offers fairly secure single-digit earnings growth and an attractive dividend yield. There is also potential for further share buy-backs over the medium term. Lonsec views WOW as a defensive stock and recommends a BUY under \$28/share.

**ORI (0.1%)** held firm after falling quite heavily during the previous month for no apparent reason apart from concerns about global growth. The company provided an update in July that confirmed it was tracking in-line for a higher profit in 2011 (September Year) than in 2010. ORI is a high quality global chemical company that should benefit from strong growth in global commodity demand and generally declining ore grades and higher strip ratios across the globe. (N.B. Lower quality ore bodies and increased overburden require more chemicals and explosives to mine and produce commodities.)

The market (broker consensus forecasts) expects ORI to earn FY11 (Sept) EPS of \$1.74, rising to \$1.95 in FY12. That implies ORI currently trades on a FY11 PER of 14.1x, falling to 12.6x in FY12. Lonsec believes these forecasts are reasonable and recommends buying ORI under \$25/share.

**WBC (-1.3%)** held up reasonably well in the lead up to the release of its FY11 (Sept) results and payment of the final dividend in November. The outlook is fairly tough in the short term with credit growth low and investment income likely to be lower. However, if the global outlook continues to worsen it is likely the RBA will cut interest rates which should help credit growth recover over the medium term.

Lonsec believes it is prudent to assume that WBC's earnings per share will be flat at around \$2.05 in FY12 and the dividend will be maintained at \$1.55 per share. That implies WBC trades on a FY12 PER of 10.6x and a dividend yield of 7.1% ff. Over the medium term, credit growth should recover as interest rates fall and economic growth recovers. This should see bank PE ratios expand again. Lonsec continues to believe that CBA and WBC are the leading major banks in terms of strategic and operational positioning, profitability and return on equity. Lonsec recommends a BUY under \$20/share.

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**IPL (-13.5%)** was sold down in September on global growth concerns and a commodity sell-off. IPL's business is roughly 50% explosives (Australia and the US) and 50% fertilisers (Australia and Asia). Explosives are leveraged to mining volumes rather than commodity prices per se and at this stage it seems mining volumes are rising in both Australia and the US. Fertiliser sales are leveraged to crop volumes in Australia and global fertiliser prices for di-ammonium phosphate (DAP) and urea. At this stage, crop volumes and fertiliser prices are firm. IPL is also helped by a falling currency, so recent weakness in the AUD/USD would be improving the translation of its USD earnings. Overall, Lonsec sees little to be concerned about at this stage. IPL is due to report its FY11 (Sept) results in early November with the market expecting a NPAT of \$536m and EPS of 33cps. On that basis, IPL trades on a FY11 PER of 10x which seems quite modest relative to its peer group and its growth potential. Lonsec recommends a BUY under \$3.40/share.

**RIO (-14.8%)** was sold down on concerns about slowing global growth. RIO's earnings are now heavily skewed towards iron ore (68% of EBITDA) and the market remains concerned that the relatively high iron ore price (US\$170 per tonne) will not be sustained, in the short term. The case for a high iron ore price revolves around strong demand from Asia, as steel production grows, and the apparent lack of ore supply outside of Australia and Brazil.

Lonsec takes the view that the iron ore price will probably fall but is still likely to settle at a reasonably high level (perhaps US\$120-130 per tonne) as there does seem to be a genuine shortage of supply. Despite these short term risks, the medium to long term outlook for RIO's commodities remains favourable. And at 7.8x 2011 forecast earnings, the RIO share price has already factored in a fair degree of downside for commodity prices, so Lonsec retains a BUY under \$65/share.

**COH (-35.2%)\*** fell heavily after announcing a voluntary recall of its Nucleus 5 (N5) cochlear implant range due to an increase in failure rates. At this stage, COH has narrowed down the fault to excess moisture shutting down one of four diodes within the implant. The moisture seems to be appearing due to a faulty seal.

COH has estimated the N5 recall will result in a one-off provision in FY12 of \$130-150m and an after-tax cash cost of \$20-30m. This implies Net Profit will fall from \$180m in FY11 to \$150-160m in FY12 or EPS of \$2.63-2.80. **The critical questions for investors are: where will earnings go in FY13 and what PE multiple should COH trade on?**

Lonsec takes the view that COH's earnings will slowly recover in FY13 and FY14 (rather than bounce back) as the company has to fix the problem with its N5 implant and then seek US regulatory approval once again. The N5 could be off the market for up to a year. In the mean-time, COH will sell its older Freedom model but this model sells for US\$12-15K per implant versus the N5 which sell for US\$25k per implant. In addition, COH could lose market share to competitors now that it has tarnished its reputation.

COH's main competitor, Advanced Bionics, had initiated its own product recall in November 2010 and has just gained approval from the US FDA (on 13 September 2011) to resell its products in the US - COH's largest market. We believe this could result in market share erosion for COH (particularly in the US and Europe) given that COH must now compete with its older Freedom implant. There is a real risk that COH's revenue and earnings could be flat to lower in FY13 and FY14.

In regards to the PE, COH used to trade on a premium PE of 22x because of its impeccable track record of earnings growth, dominant market share, high margins and high ROE. This recall is the first blemish on its track record and highlights to the market that the business has more risk than first thought. Recalls have also happened to all of COH's competitors in the past. Lonsec believes COH's PE will compress to around 15-16x which is a similar level to CSL and represents a still healthy 25-30% premium to the market PE of around 12x.

On that basis, we value COH shares between \$42-48/share with a mid-range target of \$45/share. We recognise that COH has increased its dividend to \$2.40/share from \$2.25/share, which lifts the yield to 4.5% (70% franked), but we nevertheless believe the stock will find its way down to a trading range of \$42-48/share in the short term.

\*COH was removed from the portfolio on 15 September 2011 at \$50.30/share.

### Did you know?

Lonsec releases its macro-economic outlook and recommended asset allocation each quarter in a publication titled *Investment Insight* which can be obtained from your Lonsec adviser or from [www.lonsec.com.au](http://www.lonsec.com.au).

### Lonsec Stockbroking

<b>Lonsec Investment Insight</b>	Quarterly macro-economic outlook and tactical asset allocation
<b>Lonsec Income Journal</b>	Quarterly hybrid securities journal, monthly table update and new issue research
<b>Lonsec Direct Model Portfolios</b>	Core, Income, Emerging Leaders and A-REIT Australian Equity model portfolios with monthly performance reports, regular email updates and corporate action advice
<b>Lonsec Diversified Direct Model Portfolios</b>	Fully listed, diversified Defensive, Balanced and Growth portfolios utilising ETFs, with quarterly performance reports
<b>Lonsec Stock Research</b>	ASX 200 stock research, selected small-cap research, daily bulletin and corporate action advice
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<b>Managed Discretionary Accounts (MDAs)</b>	Lonsec portfolios on Lonsec's MDA service
<b>Advisers please contact:</b>	Lonsec Portfolio Services (02) 9993 4473 or info@lonsec.com.au

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**Date Prepared:** Tuesday, 18 October 2011

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