Income Model Portfolio Performance

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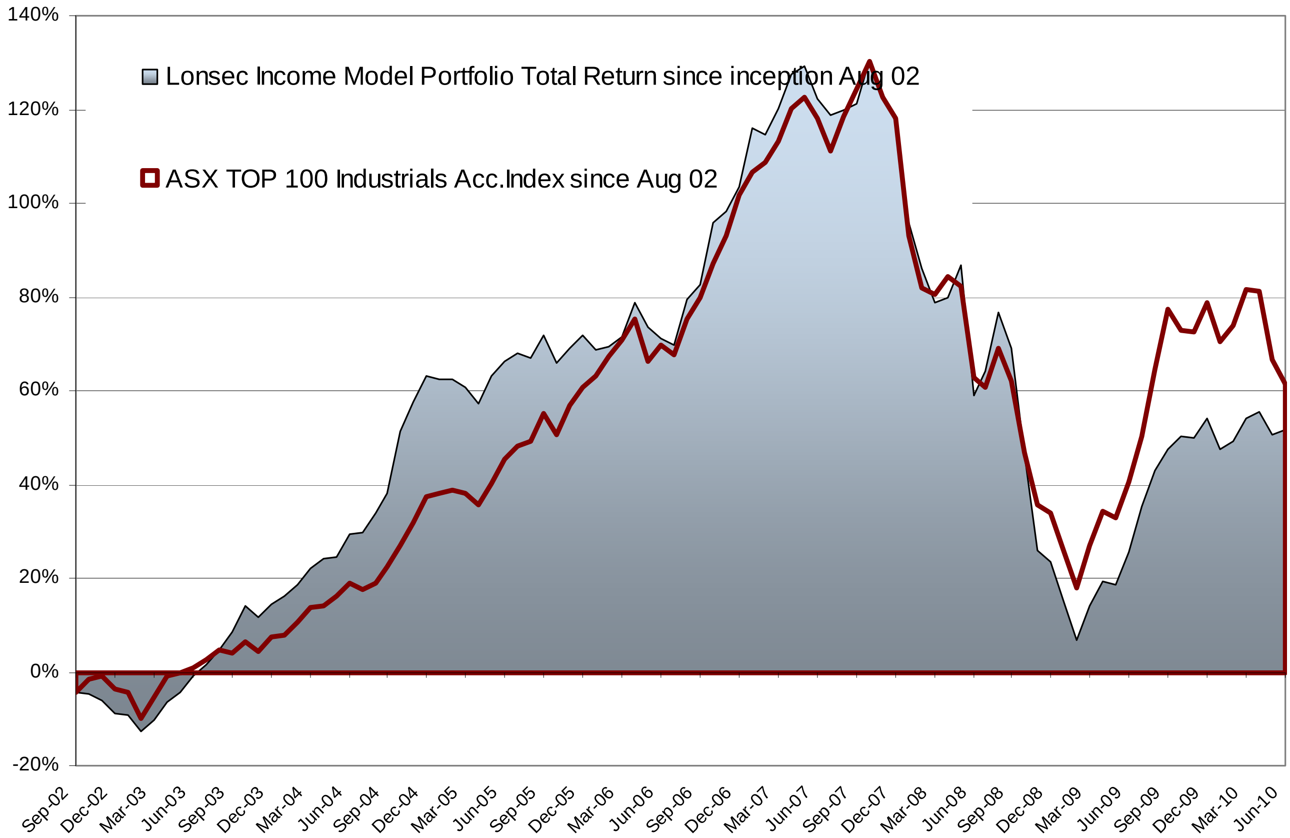

INVESTMENT PERFORMANCE Period ending 30 June 2010	Month	Qtr	Six Mths	Year	2 Yrs[1]	3 Yrs[1]	5 Yrs[1]	7 Yrs[1]	Since Inception[2]
Lonsec Income Total Return[3]	**0.9%**	**-1.5%**	**-1.5%**	**20.7%**	**-2.2%**	**-11.9%**	**-1.8%**	**6.3%**	**51.8%**
ASX TOP 100 Industrial Accumulation Index	-3.1%	-11.1%	-9.8%	14.8%	-0.3%	-9.6%	2.1%	6.9%	61.5%
Out/Under Performance	4.0%	9.6%	8.3%	5.9%	-1.9%	-2.3%	-3.9%	-0.6%	-9.7%

[1] % pa [2] Total return since inception 20 August 2002

[3] Investment Performance is calculated before fees, charges, brokerage and taxes. Dividends are reinvested at the end of each month.

The portfolio is reset at the end of each month back to the model portfolio weightings. This prevents portfolio weightings from skewing over time and ensures performance figures remain relevant. The Lonsec Income Model portfolio is a fully-invested notional portfolio with no cash weighting. Physical portfolio results will differ depending on cash levels, start date, fees, taxes and compliance with model portfolio weights. Past performance is not a reliable indicator of future performance.

Comments

"The Lonsec Income Model Portfolio seeks to deliver a high fully franked dividend yield and reasonable capital growth, over the medium to long-term"

The Income portfolio strongly outperformed for the second consecutive month, lifting the annual return to 20.7%, well above the benchmark return of 14.8%. The Income portfolio is positioned more defensively than the Core portfolio so it has been picking up performance when market sentiment is neutral or negative. The strong yearly performance brings the portfolio closer to outperforming over longer time periods.

Top contributors to performance over the year include: CCL (+44%), WES (+32%), CBA (+31%) and HSP (+23%). The portfolio has a few stocks involved in material corporate actions that should unlock further upside including HSP, CSR and TLS. Lonsec comments on these stocks in this report.

The current portfolio yield is **5.6% ff (8.0% gross),** which Lonsec believes is sustainable and should grow over time. Investors should note that the primary objective of the Income portfolio is a high sustainable fully franked yield while its secondary objective is modest capital growth, at least in line with inflation. This means the portfolio is not expected to generate large capital appreciation. Investors focused on capital growth should follow the Lonsec Core portfolio.

Note: Recommendations made within the Lonsec Model portfolios may differ from other research published by Lonsec/Aspect Huntley.

Comments on stocks with corporate actions:

CSR (+3.0%) CSR recently announced the sale of its Sugar division to a Singapore-based company. Lonsec's comments follow:

Key Points:

- CSR has agreed to sell its Sugar and Renewable Energy division, Sucrogen, to Wilmar International for an enterprise value of A$1.75bn
- CSR's demerger plans have been put on hold pending the outcome of the sale agreement
- CSR expects net proceeds of A$1.6bn and is evaluating a range of capital management options
- The sale is expected to be completed by the last quarter of 2010, subject to FIRB approval

Comments:

It seems Wilmar (a Singapore-based agribusiness group with a market cap of A$31bn) has trumped the Chinese-based Bright Food Group which was planning a similar bid albeit at a slightly lower price and with more conditions. The offer values the Sugar business at $1.75bn, including net debt of $400m. The equity value is therefore $1.35bn or around $0.90/share. This suggests that the remaining businesses of CSR, namely Building products, Property and Aluminium, are currently valued by the market at around $0.85/share. Most major brokers value these businesses at between $1.30-1.50/share. This suggests the break-up value of CSR is closer to $2.20-2.40/share.

CSR break-up value

Sucrogen	0.90/share
Building products	0.80
Aluminium/Property	0.50
Total	2.20

Source: Lonsec estimate, major broker valuations

CSR seems to have extracted a good price for Sucrogen, given A$1.75bn is the same price Bright Food originally placed on the business when the sugar price was around US$0.21/lb – the sugar price has since fallen to around US$0.16/lb.
Although Lonsec notes the AUD/USD has also fallen 10% and CSR has hedged 70% of FY11 sugar production at A$440 per tonne and 50% of FY12 at A$425 tonne, which is comparable to the relatively high average realised FY10 price of A$427 tonne. The main hurdle to the Wilmar bid will be FIRB approval but Lonsec expects less resistance to the publicly-listed Singapore bid in comparison to the state-owned Chinese bid.

CSR expects net proceeds of A$1.6bn which is a considerable sum given its market cap of $2.7bn. In effect, CSR is proposing to sell about 60% of its operations for cash. Lonsec expects that a great deal of this cash will be used to retire debt and return capital to shareholders. CSR will be left with the major Australian and NZ building products division, a small property development business and a 30% stake in the Tomago aluminium smelter in Newcastle. Lonsec expects CSR to consider selling the property development business and the aluminium investment when it can achieve an optimal price. This will leave CSR as a plain-vanilla building products company – the old conglomerate structure will be dead. Maybe WES will be the next conglomerate to see value in demerging its diverse and unrelated business operations?

Lonsec believes there is inherent value in the old conglomerate that is close to being realised. Investors should look forward to a series of higher dividends and/or capital returns. Buy below $1.80/share.

HSP (-5.5%) HSP has received a binding takeover offer at $6.26 cash per share. Lonsec's comments follow:

Key Points:

- The HSP Board recommends $6.26/share cash offer from the Carlyle Group and TPG private equity consortium
- The acquisition will be executed via scheme of arrangement
- The transaction is subject to independent expert, shareholder, court and regulatory approval
- Scheme meeting is expected to be in early October
- The acquisition should be completed in mid-to-late October
- The offer price will be reduced by any dividend paid before October

Comments:

The original private equity bidding consortium (minus Blackstone) has won the race for HSP. In Lonsec's view, the HSP Board has extracted a full offer for the company. The market (broker consensus estimates) expects HSP to generate FY10 EPS of 33cps implying the offer values HSP at 19x earnings. However, Lonsec's portfolio manager expects HSP FY11 earnings to increase to around 40cps due to strong growth in the hospital portfolio, implying a FY11 PER of 15.6x. Regardless, the offer is full and is likely to be endorsed by the independent expert and shareholders. Lonsec doesn't expect any issues from the ACCC or the Foreign Investment Review Board given its modest industry impact.

From here the shares are likely to trade at a small time-value discount to the $6.26/share offer which will narrow as the transaction passes each approval and nears completion in October. Lonsec understands that financing has been secured and there are no conditions related to market movements. In Lonsec's view, the transaction has a high probability of concluding in October. That said, HSP shareholders may wish to bank profits and move to cash when the share price trades above $6. Lonsec will remove HSP from the Core portfolio within the next 1-3 months.

Comments on major outperformers during the month:

TLS (+10.5%) Telstra recently announced a non-binding agreement with the Government regarding the National Broadband Network (NBN). Lonsec's comments follow:

Key Points:

- TLS has signed a non-binding agreement to co-operate with the rollout of the NBN
- TLS will receive approximately $11bn (in post-tax NPV terms) in consideration for:
    1. decommissioning its copper network and cable broadband;
    2. allowing the NBN Co access to its infrastructure; and
    3. gradually shifting its copper and cable customers to the NBN
- TLS will also be released from its Universal Service Obligations and be allowed to bid for Long Term Evolution wireless spectrum
- The agreement is subject to legislative approval, ACCC approval, independent expert review and TLS shareholder approval
- TLS expects to put a final agreement to shareholder vote in the first half of 2011

Comments:

This agreement, while non-binding, is still a significant step towards a more positive outcome for TLS and indeed the NBN. It has been reported that TLS had wanted $12bn in compensation but the NBN was initially only prepared to pay $8bn. It now seems TLS will receive $11bn but the NBN will only pay $9bn while the extra $2bn will come from the Federal Government via policy reforms. One wonders if the heat from the mining super tax and subsequent battering in the polls has made the Government more desperate to announce a deal with TLS. In any case, it looks to be a win-win situation for TLS and the NBN. The NBN was never going to make sense while TLS could compete with it using its existing copper and cable network.

If the agreement goes ahead, TLS will be free of its highly regulated wholesale fixed line business. It will concentrate on retailing of voice and fixed-line broadband and its wholesale/retail wireless broadband business plus its various investments in Foxtel, Sensis and Soufun. Lonsec understands that Foxtel will continue to be delivered by TLS cable in the short to medium term. TLS will be able to use the $11bn in compensation (to be received over time) to pay down debt and reposition itself in the competitive segments of telecommunications and media away from the highly regulated fixed-line segment.

Lonsec's portfolio manager is of the view that this agreement could lead to a 'sea-change' in the way TLS is viewed by the market. If it is executed, TLS will significantly reduce its regulatory burden and a new management team may be able to reposition the company for growth. Already, early broker valuations are implying valuations of around $4.00 on TLS. This won't be priced in immediately as there is still some way to go before the transaction is executed but the future is suddenly looking brighter for TLS. Lonsec retains TLS in the Income portfolio and recommends a BUY under $3.50/share.

CCL (+9.9%) Coca-Cola Amatil recently provided a market update:

Key Points:

- CCL confirms previous guidance of high single digit growth in EBIT and NPAT for 1H10
- Australia – solid start to the year, positive volume growth and further efficiencies
- Indonesia – strong volume growth of 10%, expecting double digit (local currency) growth
- Food – slow start but high single digit earnings growth expected
- Pacific Beverages – up to 10% market share of the premium beer market in Australia

Outlook:

"It is too early to assess what impact the cumulative effect of the interest rate increases and a less certain global economic outlook will have on consumer confidence and spending in the second half of 2010. CCA will continue to focus on executing its organic growth strategy. We have a strong pipeline of high returning capital projects that are expected to deliver efficiency and revenue gains across the business for the next few years. We will also continue to up-weight our investment in Indonesia, and with the Bluetongue Brewery about to be commissioned, we will have the manufacturing platform to take our beer business to the next level." - CCL CEO, Terry Davis

Comments:

CCL looks to be on-track for another year of solid earnings growth. CCL has a very strong Australian business supplemented by two growth stories, namely distribution in Indonesia and the beer business in Australia (Pacific Beverages). Pacific Beverages is a joint venture with SABMiller, the world's 2nd largest brewer, that was established in 2006 to distribute alcoholic beverages through CCL's distribution networks.

Already, the joint venture has about 10% of the premium beer market with brands including Peroni, Miller, Grolsch and Bluetongue.

CCL reports on a Dec year with the market (broker consensus) expecting a FY10 NPAT of $500m, equivalent to EPS of 67cps and DPS of 48cps ff. On that basis, CCL trades on a FY10 PER of 17.5x and yield of 4.1% ff. The stock looks fully valued at these levels but Lonsec notes the company usually exceeds guidance each year. Lonsec recommends investors BUY under $11/share.

AGK (+6.3%) AGL recently upgraded its earnings guidance:

Key Points:

- AGL upgrades underlying FY10 NPAT guidance to $420-430m (up from $390-420m)
- The FY10 result will be released on 26 August 2010

Comments:

The AGL share price has been volatile of late, falling from $15.50 to $13.50 from April to May and then recovering to $14.70 by July. This volatility probably reflects general weakness in the energy sector due to changes to resources and energy taxation policy but AGL is not materially affected by the proposed changes. AGL is similar to ORG in that it has adopted a vertically integrated energy strategy but it differs in that its upstream production is more biased to renewable energy (rather than gas) including hydro, wind, landfill and biomass. Despite the Government delaying the implementation of a carbon tax, it has legislated for 20% of Australia's electricity supply to come from renewable energy by 2020. There is also a renewable energy certificate (REC) market starting to develop in Australia. Renewable energy is likely to become a growth industry this decade and AGL is well positioned to capitalise on such growth.

AGL's profit guidance of $420-430m is a little higher than the current broker consensus estimate of $420m. AGL's guidance is likely to be conservative, so Lonsec's portfolio manager is comfortable adopting a FY10 NPAT forecast of $430m, equivalent to EPS of 95cps and DPS of 60cps. On that basis, AGL trades on a FY10 PER of 15.4x and a dividend yield of 4.0% ff. The stock seems reasonably priced given the company should generate, at least, high-single-digit earnings growth over the medium term. Lonsec recommends a BUY under $14.50/share.

Comments on major underperformers during the month:

WBC (-7.5%) Westpac has been weak over the past two months in line with general weakness in bank stocks globally and domestically. European sovereign debt issues are sparking concerns about another wave of bad debts for European banks. While Australian banks hold little European sovereign debt as assets, they do fund a considerable portion of their wholesale debt in European debt markets. If credit spreads start to rise in Europe the cost of capital will go up for Australian banks meaning they will have to increase loan rates and/or absorb some of the cost through lower interest margins. At this stage, Lonsec does not expect a repeat of the GFC, where the Australian Government had to lend its AAA credit rating to the banks so they could continue to access foreign debt markets on reasonable terms.

At the same time, credit growth is stalling in Australia and recent equity market weakness will crimp investment income. The outlook does look less rosy than a couple of months ago but the major banks are now in a strong position to cope with any economic or market weakness.

In the case of WBC, it has increased interest margins to 2.28% and ROE to 16.6% and it has a strong capital position with a tier 1 capital ratio of 8.6% and an additional collective provision of 1.5%. It retains a AA credit rating (one of the top 10 rated banks in the world) and has a market capitalisation of $67bn, making it Australia's 2nd largest bank after CBA.

Asset impairment charges have been falling since the GFC from $1.6bn per half to around $880m in the most recent interim result. A decline in asset impairment charges goes straight to the bottom line, so WBC still has plenty of room to grow cash earnings if this charge continues to come down.

The market (broker consensus) currently forecasts FY10 NPAT of $5.9bn equivalent to EPS of $1.95 and DPS of $1.35. On that basis, WBC trades on a FY10 PER of 11.4x and dividend yield of 6.0% ff. The stock looks good value at these levels and Lonsec recommends a BUY under $23/share.

For further information on the top-down outlook, tactical asset allocation, model portfolios and bottom up stock research, please review Lonsec's ***Investment Insight*** quarterly report and direct equity research on the web: **www.lonsec.com.au** and/or contact Lonsec Stockbroking via email **broking@lonsec.com.au** or call the Melbourne Desk **1800 648 518** or Sydney Desk **1800 155 514.**

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