

Movement of Market Indices for the September Quarter 2009

Index	30 Sep 2009	% Change
All Ordinaries	4739	20.0%
Banks	6694	35.6%
Materials	11233	10.8%
Industrials	3865	29.0%
Real Estate	2253	29.2%
US S&P 500	1057	15.0%
UK FTSE 100	5134	20.8%
Japan Nikkei	10133	1.8%
German DAX	5675	18.0%
Shanghai Comp	2779	-6.1%
Hang Seng	20955	14.0%
RBA Cash Rate	3.00%	0bp
90 Day bill rate	3.39%	+20bp
10 year bond	5.44%	-19bp
Oil (WTI) \$US	\$70.61	1.13%
Gold \$US	\$1009	0.52%



Will the inflation genie emerge?

A battle is raging between the forces of inflation and deflation. On one side, Governments and Central Banks are providing major economic stimulus while on the other side a de-leveraging cycle in the private sector threatens to induce a long period of reduced demand and increased savings.

Government and Central Bank stimulus has fuelled a recovery in the global economy and financial markets but there are ongoing questions about the sustainability of the recovery.

Is Government and Central Bank liquidity hiding a debt deflation cycle in the Western world? Debt deflation occurs when the private sector seeks to reduce debt levels by selling assets and increasing savings. Private demand declines leading to excess capacity and the price of assets, and goods and services fall. It may be years before investors can determine whether the US is headed for a Japan-style deflationary period.

Another question is: when will the bill fall due for all this Government and Central Bank stimulus? It seems taxes will eventually have to rise to service and repay the burgeoning public debt burden, otherwise sovereign risk will continue to rise.

Certainly Asia looks much cleaner in terms of economic fundamentals and sustainable growth. Lonsec's recent trip to China confirmed that the economy is flush with capital and is a much broader consumption and investment story in addition to net exports.

Australia's economic fundamentals also look quite strong, relative to most OECD countries, and our increasing links with Asia bodes well for the future. Australia's weakness is the high leverage of the economy to the housing sector but a rising population and strong banking system mitigate these concerns. Australia should continue to outperform most OECD economies implying the AUD will continue to strengthen.

Overall, Lonsec expects deflation now but inflation later, due to the seemingly unlimited capacity of Government and Central Banks to supply liquidity to support the financial sector and the economy. In addition, growing Chinese consumption should help absorb excess global capacity. Indeed, there is a risk that inflation emerges quicker than Central Banks expect.

The emergence of inflation will see rising bond yields and falling bond prices. On that basis, Lonsec continues to move underweight bonds and overweight growth securities. Lonsec favours Australian equity exposure over International; International weightings should be tilted to Asia.

The All Ordinaries Index is expected to correct in the December quarter but then continue its march to 5,000. The major risk remains the US lead and a 'W' shaped US economic recovery. Given the poor fundamentals of the US economy relative to the Australian economy one would expect the Australian market to disconnect from the US lead, in the long term. It may be some time off, but it seems our future is increasingly tied to Asia.

Global Economic Outlook

Fragile recovery with Asia leading the world out of recession

The IMF has upgraded its outlook for global growth, with activity expected to decline by 1.4% over 2009 and expand by 2.5% over 2010. Developed economies (which represent about 65% of global GDP) are expected to grow by 0.6% over 2010, while developing economies (35% of global GDP) are expected to grow by 4.7%. The IMF expects a weak recovery in developed economies and a moderate recovery in developing economies.

The US economy (23% of Global GDP at market exchange rates)

Recent data flow has improved in the US, although the recovery still looks fragile. The unemployment rate has increased to 9.8% (the highest since 1983), but monthly payroll decline has reduced to around 300,000 down from 700,000, six months ago. The financial crisis wiped out a great deal of US wealth but the S&P500 has since recovered 54% since the March low and the housing market looks to have found a base and is slowly recovering. Post financial crisis, US consumers have gone into their shells and are seeking to pay down debt. The savings rate in the US has jumped to 5.9% — the highest level since 1995. This is bad news for US consumption, which has grown to represent over 70% of the US economy.

Fiscal and monetary policy has been turned to maximum stimulus with the US Federal Reserve cutting interest rates to zero and printing money to buy US mortgage-backed securities and US bonds in an effort to keep a lid on mortgage rates. The Federal Government is spending huge amounts supporting the financial system and the real economy and is expected to run a budget deficit exceeding US\$2trillion or 14% of GDP. These efforts seem to have stabilised the US economy, in the short term at least, but have led to a weakening USD.

The big picture is the US economy is heavily indebted, with US\$42 trillion in debt across the private sector and US\$10 trillion in debt across the public sector, against an economy worth US\$14 trillion. The US has many years of low growth ahead as consumers reduce spending to pay down debt, and the Government will eventually have to reduce spending and/or increase taxes to do the same. The IMF forecasts the US economy will grow by 0.6% over 2010.

The European economy including the UK (21% of Global GDP)

Europe does not look much better than the US with forecasts for a mild recovery after a deep recession. Unemployment in Europe (currently at 9.6%) also looks likely to exceed 10% by the end of 2009. It seems the member states outside France and Germany have deeper economic troubles, particularly Ireland, Spain, Italy, Greece and various Eastern European states. The ECB has cut the cash rate to 1.0% and, like the US Federal Reserve, is embarking on some limited 'quantitative easing' (purchase of bonds to try and keep bond yields low). However, Europe still seems reluctant to investigate the solvency of its Banks, particularly those with Eastern European exposure, while Germany seems very reluctant to provide fiscal stimulus. This complacency could hinder the Eurozone's recovery.

The UK seems to be acting more decisively than Europe but is still in a deep recession because debt levels are higher and the decline in the housing and financial sectors has been greater. The BOE has slashed the cash rate to 0.5% and is also engaging in 'quantitative easing', while the Government has been busy providing support for the Banking sector and the real economy with a £20bn fiscal stimulus package. The Government's Budget deficit is set to rise to £118bn (12% of GDP) over the year. The IMF expects the European economy to decline -0.3% and the UK economy to grow 0.2% over 2010.

The Asian economy (21% of Global GDP)

After a dismal first half, the Japanese economy is showing signs of recovery. Improved consumer confidence, a rebuild of inventories and a strong turnaround in net exports are expected to lift growth in coming quarters. The Nikkei has recovered 39% from its March low and the recent Tankan survey reported that business confidence has recovered to -33 from its record low of -58 in 1Q09. The Bank of Japan has cut interest rates to 0.1% from 0.3% and the Government is mulling over a new stimulus plan, although with a public debt to GDP ratio of 165%, its options are limited. Deflation will probably re-emerge as a problem for the Japanese economy during 2010.

China has moved decisively to head off the collapse in global trade that has harshly affected similar export-dependent economies like Japan, Korea and Germany. The Chinese Government released a 4 trillion yuan (US\$585bn) stimulus package focused on stimulating internal consumption and investment. At the same time, Chinese State-owned Banks lent US\$1.2 trillion in the first six months of 2009 — more than was lent over the entire 2008 year! There are signs this massive stimulus is indeed boosting economic growth but there are some concerns about new asset bubbles in property and shares. The IMF expects the Japanese economy to grow 1.7% and China's economy to grow 8.5% over 2010.

Key global issues to watch	Lonsec view
Global credit conditions	Credit conditions likely to remain tight, bond yields at risk of rising over 2010
G7 economic growth	Mild recovery over 2010
Inflation/Deflation	Deflation more likely in the short term due to build up of excess capacity but Government liquidity could lead to inflation emerging later
Asian economic growth	China to maintain an 8% growth rate; Japan to experience a mild recovery
Commodity prices	Likely to remain buoyant as OECD demand recovers and USD continues to remain weak

Domestic Economic Outlook

Australia to avoid official recession and continue to outperform the OECD

The Australian economy is proving resilient and looks likely to avoid an official recession (defined as two negative quarters of economic growth). However, the last four quarterly growth figures of 0.2%, -0.6%, 0.4% and 0.6% clearly show the economy has slowed significantly.

The Federal Government and Reserve Bank of Australia (RBA) moved quickly to counter the negative effects of the global credit crisis and evolving global recession. The Government implemented two stimulus packages equivalent to \$52bn or 4-5% of GDP, while the RBA moved swiftly to cut the cash rate by 425bp to 3.00%, over a period of 8 months. With the economy avoiding recession, the RBA has now begun the process of increasing the cash rate to more 'neutral' levels, thought to be in the range of 4-5%.

Australia's strong fundamentals relative to most OECD countries include:

- The financial system is stable and functioning normally;
- The economy is growing;
- The Government is in a relatively strong fiscal position;
- The unemployment rate remains relatively low at 5.7%;
- House prices have proven fairly resilient to date; and
- Asia, Australia's major export partner, is still growing.

The combination of Australia's relative economic strength and a weakening USD has led to the AUD strengthening to US\$0.90, at the time of writing. While a rising currency hurts our export competitiveness, it isn't all bad news as Australia still runs a current account deficit. Put simply, Australia imports more than it exports and it also borrows a large amount of capital offshore (about \$680bn in debt). A rising currency lowers the cost of imports and reduces our interest costs in AUD terms. It is probably a net positive in the short term but will tend to lead to long-term problems if our current account deficit continues to expand.

With consumer and business confidence rising, consumption and investment should rebound over 2010. Finance is generally available but some sectors, like commercial property development, still have restricted access. The housing sector could also add to growth, given that housing starts of around 130,000 pa are well below estimated demand of 180,000 pa. Rising house prices and relatively cheap finance are expected to provide the incentive for new housing construction, over the short to medium term.

The main risks to the economy are inflation, a rising currency and any faltering of growth in China. While headline inflation has fallen to 1.5%, the underlying rate has remained stubborn at 3.6%. If monetary and fiscal stimulus remains expansionary for an extended period there is a risk underlying inflation will start trending up. This could drive interest rates higher and lend further strength to the AUD. Rising interest rates would dent consumption and investment, while a rising AUD could seriously affect Australia's export income. Any faltering in China's growth path would exacerbate the risk to export income. Lonsec expects that inflation will be subdued in the short term but is concerned that it could re-emerge as a real issue over the medium term. Accordingly, Australian interest rates are expected to move higher from here.

Overall, the economy should continue to recover over 2010 and 2011. The RBA will increase rates but will be mindful of AUD strength. China and broader Asia will become increasingly important to the Australian economy, in terms of trade and capital flows. The IMF expects the Australian economy to grow 0.7% over 2009 and 2.0% over 2010.

Key local issues	Lonsec view
Cash rate	Cash rate to gradually increase to 4.0% by June 2010
Unemployment	Unemployment rate to peak at 6.0%
AUD/USD	Highest cash rate in the G20 likely to support AUD, risk of going past \$1.00 if US Government continues to supply liquidity to the US economy and financial system
Commodity Prices	Likely to remain buoyant as OECD demand recovers and USD continues to remain weak
House Prices	Average house price to increase over 2009 but higher rates and roll-off of FHB should cap growth in 2010
Bond yields	Australian bond yields to rise as underlying inflation starts to become an issue

Recommended Tactical Asset Allocation

Lonsec continues to increase its growth allocation this quarter with the Australian equity weighting being lifted to slightly overweight. Lonsec is generally positive on the economic outlook for Australia and Asia but has reservations about the US and Europe. The USD is expected to remain weak in the short to medium term. There is currently much debate over whether to expect deflation or inflation. Lonsec takes the view that we will experience deflation now and inflation later. It is likely that Government and Central Bank stimulus will eventually stoke inflation, which will be bad news for bonds ie bond yields will rise and hence prices will fall. Accordingly, Lonsec continues to move underweight bonds. Finally, the growth allocation is likely to be further increased in future quarters but the focus will be on Australian Equities and Property rather than International.

Investment Category	Asset Class	Sept 09 Quarter*	Dec 09 Quarter
Income	Cash	Overweight	Overweight
Income	Australian Fixed Interest	Neutral	Slightly Underweight
Income	International Fixed Interest	Underweight	Underweight
Growth	Australian Property (LPT)	Neutral	Neutral
Growth	Australian Equities	Neutral	Slightly Overweight
Growth	International Equities (Unhedged)	Neutral	Neutral

*Note intra-quarter change made on 22 July 09

Cash – Overweight

The RBA has begun the process of lifting the cash rate from its historic low of 3.0% which had been put in place to insulate the economy against a global recession. Recent economic data confirms the Australian economy has avoided recession and indeed has outperformed most OECD countries. Accordingly, the market now expects the cash rate to revert back to more 'neutral' levels of between 4-5% over the next financial year. Lonsec is a little more reserved and expects the cash rate to slowly rise to 4.0% by June 10 because the RBA will need to be mindful of the risks of the global recovery faltering and the possibility of driving the AUD well past US\$1.00.

Australian Fixed Interest – Slightly Underweight

Australian Government and Corporate bonds have recently rallied as inflation concerns abate and credit spreads narrow. If the cash rate reverts to around 4.0% there will be a narrow spread between the cash rate and 10-year bonds at 5.26% ie the yield curve is expected to flatten. Lonsec is not as concerned about increased bond issuance as it once was as the Budget deficit looks to be more modest than previous estimates. Public (Federal and State) debt levels look set to peak at around \$150bn rather than \$250bn in 2012/13 forecast by economists. However, Lonsec still remains concerned that inflation will return over the medium to long term and hence bond yields will rise ie bond prices will fall. Based on this view, Lonsec is reducing its bond exposure to slightly underweight.

International Fixed Interest – Underweight

Lonsec finds the investment case for global bonds to be unattractive as yields range from 3.0% to 3.5% on most major global 10-year bond issues. The return seems inadequate given the supply of most issues will increase dramatically as G20 Governments issue debt to finance ballooning Budget deficits. You would only find global bonds attractive if you believe the global economy is in for a lengthy period (5 years+) of deflation, which is not Lonsec's base case scenario. Lonsec believes that at some point in the future, Central Banks and Governments will be successful in jump-starting inflation either by conventional or non-conventional means ie money printing.

Australian Property (LPT or A-REIT) – Neutral

Lonsec has been Neutral on the LPT sector for the past year because it has suffered a major correction and the nine major trusts have largely recapitalised now. Indeed, the sector has rallied 70% from its March low as the large discount to NTA has narrowed. However, the sector is still down 60% from its 2007 high.

From here, the focus will be on where cap rates settle for each type of commercial property and future distribution growth. Lonsec believes the sector will be more 'plain vanilla' from now on, meaning trusts will deliver a relatively high running yield with only modest capital growth over the long term. The major risks facing the sector are continued access to debt finance at competitive rates and rising bond yields. If 10-year bond yields begin to rise, as Lonsec expects, investors will require a higher yield from A-REITS hence the sector's recovery may be capped. That said, Lonsec is positive on the Australian economy and AUD dominated assets. We may consider increasing the A-REIT weighting on any pullback in the sector.

Australian Equities – Slightly Overweight

The local market has recovered 54% from the March low but is still down 30% from its 2007 high. Given the strong fundamentals of the Australian economy, relative to most OECD countries, it is reasonable to expect the market to continue to rise towards 5,000. However, it would be over optimistic to expect a rapid recovery back to the 6,800 level, as investors must take into account the dilutive effect of the \$100bn in equity that has been raised over the past year.

In some sectors, like Banking and Consumer Staples, the market capitalisation of companies is now larger than it was at the 2007 peak! This suggests the market will near full valuation at some lower level, perhaps 5,000, unless there is a major recovery in earnings growth. Indeed, the major sectors of the market are starting to look fully valued, in the short-term:

Sector	Market weight	FY10 PER*	FY11 PER*
Resources	31%	20.8x	16.7x
Industrials	29%	15.7x	14.0x
Banking	25%	15.3x	12.5x

*based on broker consensus estimates

The Australian economy is expected to grow 1.5% over FY10 but is expected to gather momentum as expansionary fiscal and monetary policy gains further traction and Asia continues to grow at a solid pace. Judging by current pricing, the market is expecting company earnings to rebound by at least 20% in FY11.

The main risks to keep an eye out for are: renewed weakness in the US economy leading to a fall in the S&P500; continued AUD strength and its impact on export competitiveness; rising domestic interest rates and the impact on domestic demand; and any hiccups in Asia, particularly China and India, affecting our exports. Regulatory risk is another risk that is on the increase of late. The Labor Government is reviewing regulation and licences in a number of industries including Banking, Wealth Management, Health, Telecommunications, Gaming and Media. The outcomes may have an adverse impact on certain sectors and need to be watched closely.

Lonsec is generally positive on the fundamentals of the Australian economy and its increasing links to Asia. The US economy is now less relevant to Australia than in the past but investor sentiment is still driven by the US lead. It seems that if Australia's future is increasingly tied to the developing economies of Asia then the US lead will become increasingly irrelevant. Indeed, one would expect the domestic market to eventually decouple from the US at some point. That is a big call, but one that should not be dismissed.

Given the strong run in the market since March, a correction over the December quarter is likely as profit taking sets in. Lonsec recommends that investors use any pull-back to move to Slightly Overweight.

International Equities (Unhedged) – Neutral

Financial markets have rebounded since March 2009. Apart from a rising unemployment rate, most of the US data has improved over the US summer and results from the 2Q and 3Q US reporting season have surprised on the upside. Consumer and business sentiment is also improving across the US, Europe and Asia. China's fiscal and monetary stimulus looks to have been successful, with 2Q GDP growth of 8.0% (annualised). This is providing hope that the Asian region can decouple from the US.

These are all signs that the global economy is stabilising and hope for a gradual recovery is rising. It does seem the major downside risks are now diminishing and that investors are becoming less risk adverse. Lonsec still has concerns about the high debt levels across the private and public sectors of the US, Europe and Japan, but believes these issues will be addressed over the medium to long term. In the short term, equity markets are likely to rise, as risk premiums contract to normal levels.

Lonsec expects global growth to be subdued, due to still tight credit conditions and the deleveraging process that has now begun across the private sectors of the developed world. Private demand will struggle while consumers, particularly in the US, look to increase their savings rate and pay down debt. Lonsec notes that the troubled economies of the US and Europe represent the vast majority of the MSCI World Index at 55% and 31%, respectively.

Overall, Lonsec expects AUD to outperform USD denominated assets and accordingly is moving to Overweight Australian equities and remain Neutral on International Equities. Our recommendation is to tilt International weightings to Asia.

Lonsec Direct Model Portfolios

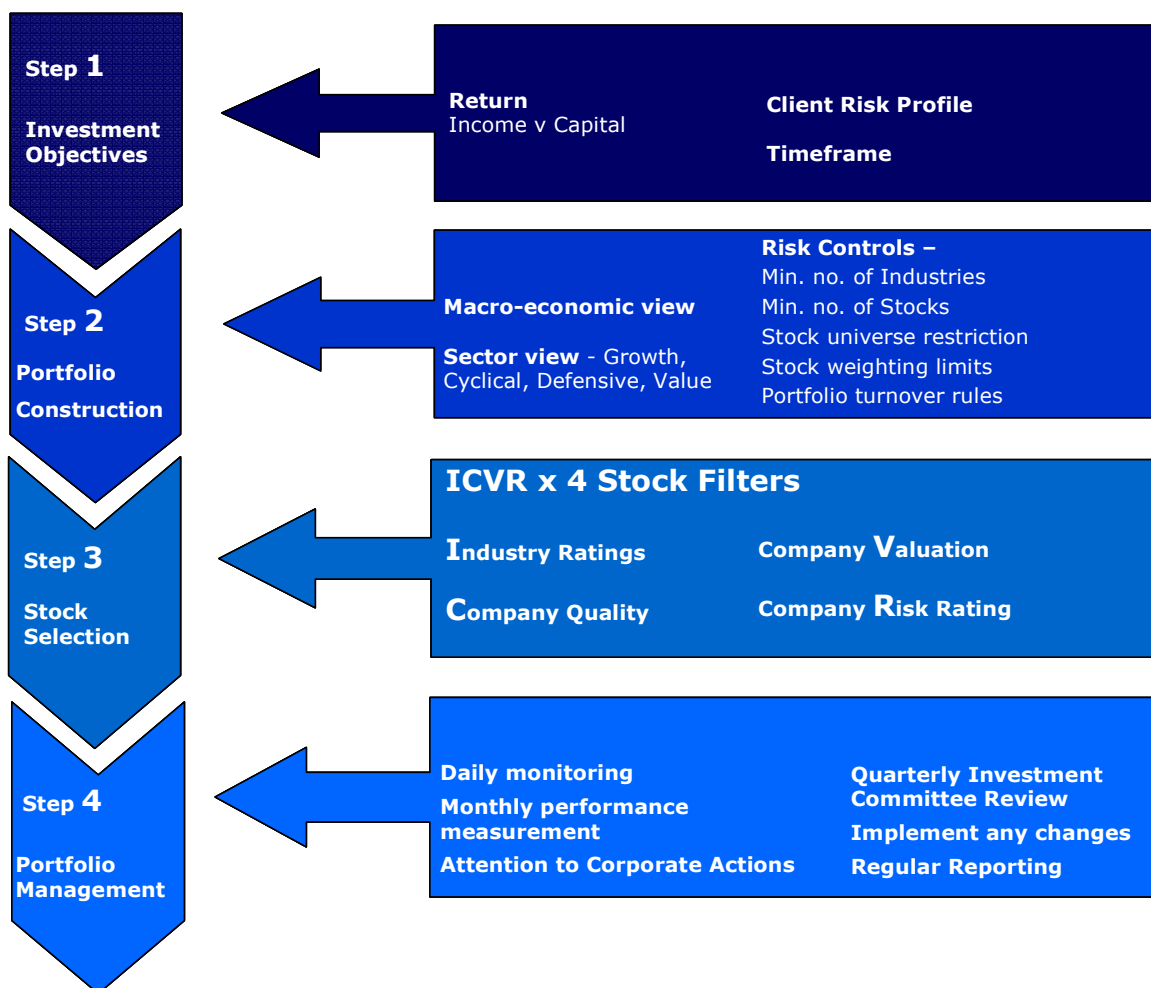
Lonsec Investment Philosophy

Lonsec takes an active approach to investing and focuses on generating absolute returns, over the medium to long term, through high conviction portfolios.

Lonsec employs a four-step investment process that has a strong focus on “top-down” macro-economic and sector themes. Risk is managed at both the portfolio and individual stock level.

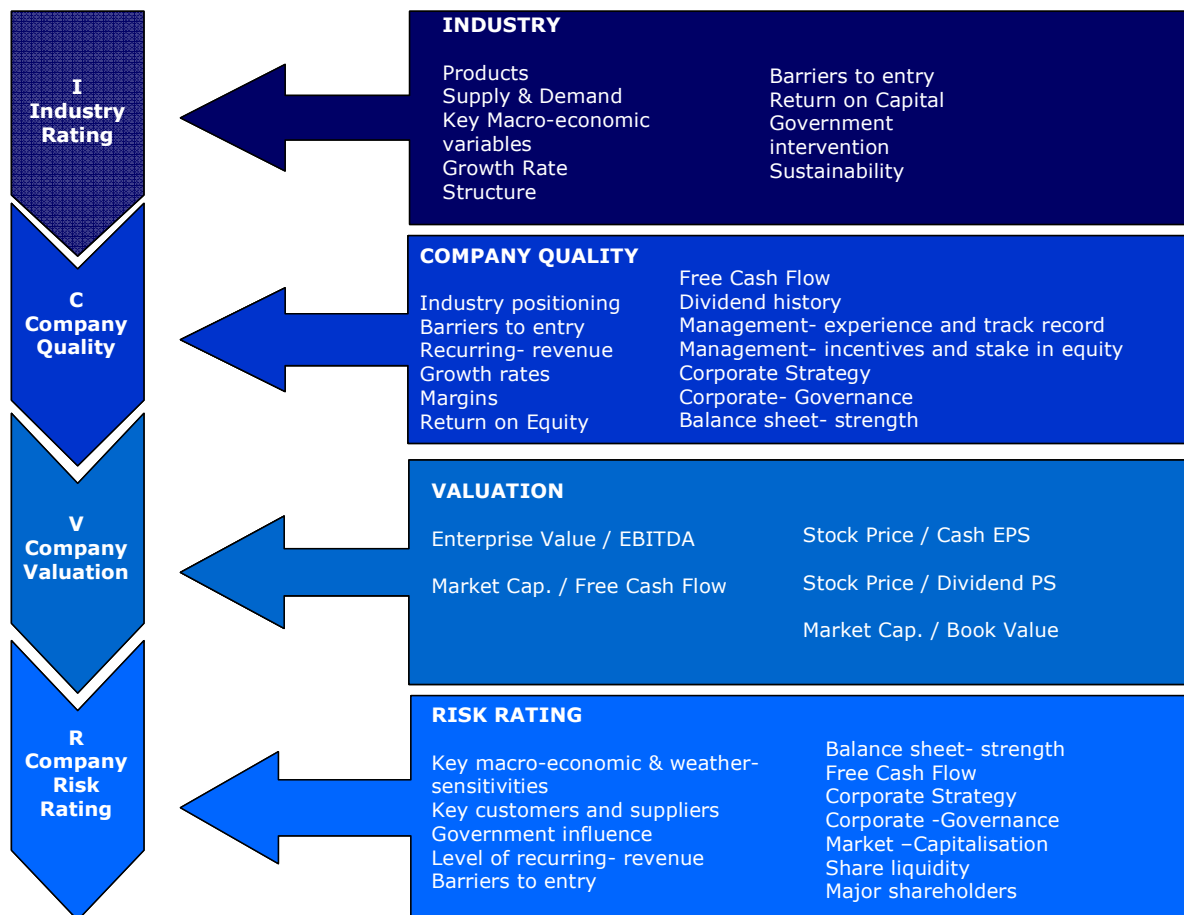
Lonsec’s Top-Down Investment Process

Lonsec employs a four-step investment process. The portfolio is heavily influenced by top-down themes at the Portfolio Construction level (Step 2). We employ four stock filters (Industry, Company quality, Valuation and Risk) to select stocks at the Stock Selection level (Step 3). Risk is managed at both the Portfolio Construction and Stock Selection levels. The final step is to manage the portfolio and regularly review our top-down themes and stock selections.



Lonsec’s Stock Selection Filters (ICVR)

Each stock is selected after a rigorous qualitative and quantitative analysis involving four stock filters. A Lonsec stock will have high ratings in each category based on our analysis and judgement.



Lonsec Core Model Portfolio

Objective

To deliver strong absolute returns, over the medium to long term, through a diversified “blue-chip” portfolio invested across a number of industries.

Portfolio Rules

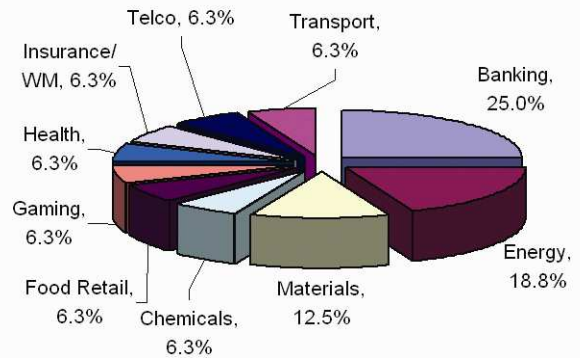
Investment universe	ASX TOP 150
Benchmark	ASX TOP 100 Accumulation Index
Min. no. of stocks	10
Min. no. of industries*	8
Individual stock limit	12.5%
Cash weighting	0%
LPT weighting	0% (Refer to Property asset allocation)
Targeted portfolio turnover	30% pa

*Note: industry is a subset of the broader GICS sector.

Portfolio Profile

PORTFOLIO EXPOSURE BY INDUSTRY		Weight
Banking	Banking	25.00%
Energy		18.75%
Materials	Material	12.50%
Chemicals		6.25%
Food Retail	Food R	6.25%
Gaming		6.25%
Healthcare	Health	12.50%
Insurance/WM		6.25%
Transport	Transp	6.25%
Total		100.00%
TOP 50		87.50%
Ex-TOP 50		12.50%

Core Portfolio by Industry



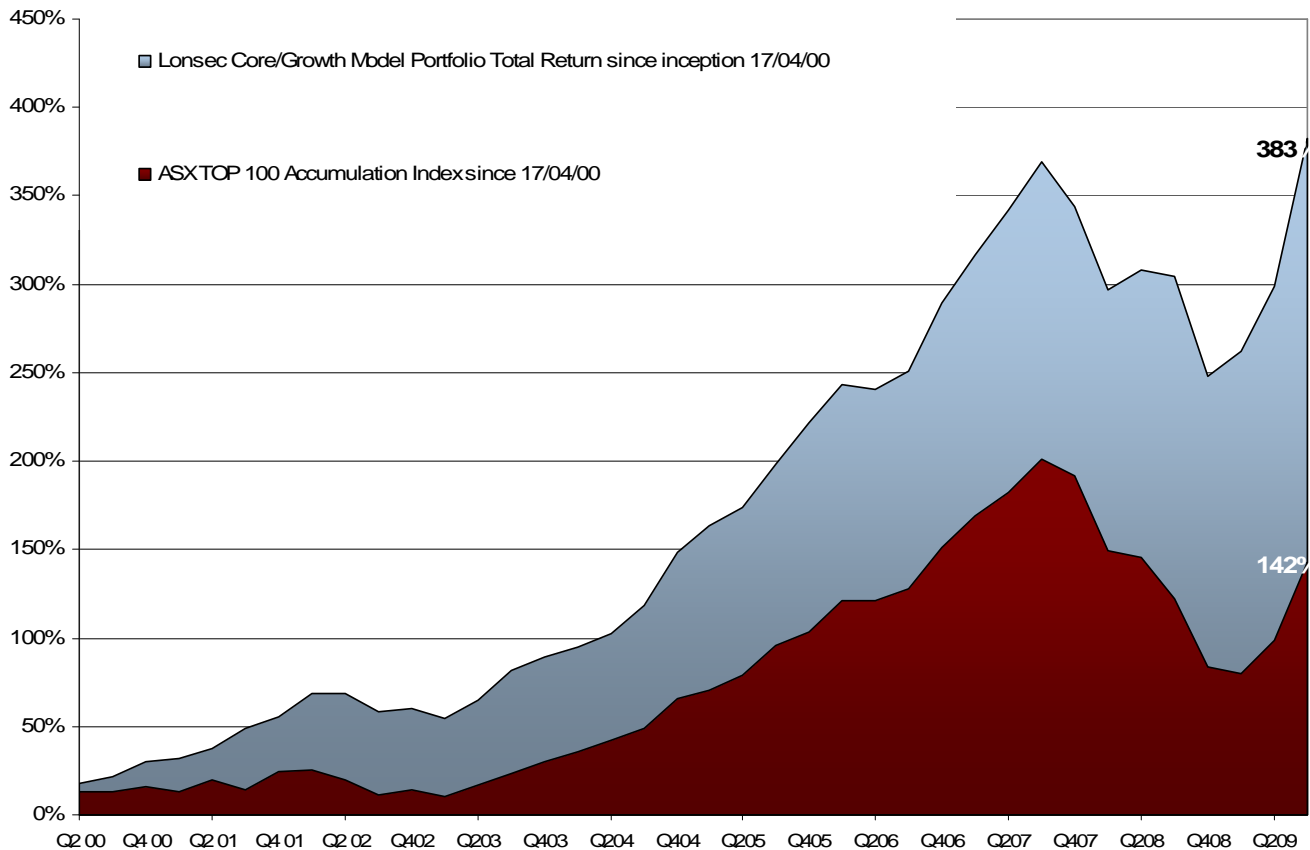
Portfolio Performance

INVESTMENT PERFORMANCE						3 Years	5 Years	7 Years	9 Years	Since Inception	Since Inception
Period ending	30 September 2009	Month	Qtr	Six Mths	Year	(pa)	(pa)	(pa)	(pa)	(p.a.)	¹
Lonsec Core Model Total Return²		7.0%	20.9%	33.4%	19.3%	11.2%	17.2%	17.3%	16.5%	18.1%	382.7%
ASX TOP 100 Accumulation Index		6.6%	21.9%	34.7%	9.3%	2.2%	10.3%	11.8%	8.9%	9.8%	142.4%
Out/Under Performance		0.4%	-1.0%	-1.3%	10.0%	9.0%	6.9%	5.5%	7.6%	8.3%	240.3%

¹ Inception date 17 April 2000

² 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 Core 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 weights. Past performance is not a reliable indicator of future performance.



Lonsec Income Model Portfolio

Objective

To deliver an attractive fully-franked income yield together with some capital growth, over the medium to long term, through a focused income portfolio.

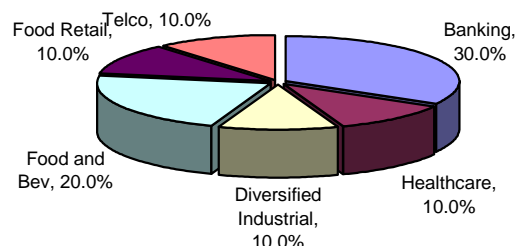
Portfolio Rules

Investment universe	ASX TOP 150
Benchmark	ASX TOP 100 Industrial Accumulation Index
Min. no. of stocks	8
Min. no. of industries	4
Individual stock limit	12.5%
Minimum franking	100%
Cash weighting	0%
LPT weighting	0% (refer to Property asset allocation)
Targeted portfolio turnover	30% pa

Portfolio Profile

PORTFOLIO EXPOSURE BY INDUSTRY		Weight
Banking	Banking	30.0%
Healthcare	Healthcare	10.0%
Diversified Industrial	Diversified	10.0%
Food and Beverages	Food and Bev	20.0%
Food Retail	Food Retail	10.0%
Telco	Telco	10.0%
Utilities	Utilities	10.0%
Total		100.0%
TOP 50		80.0%
Ex-TOP 50		20.0%

Portfolio by Industry



Portfolio Performance

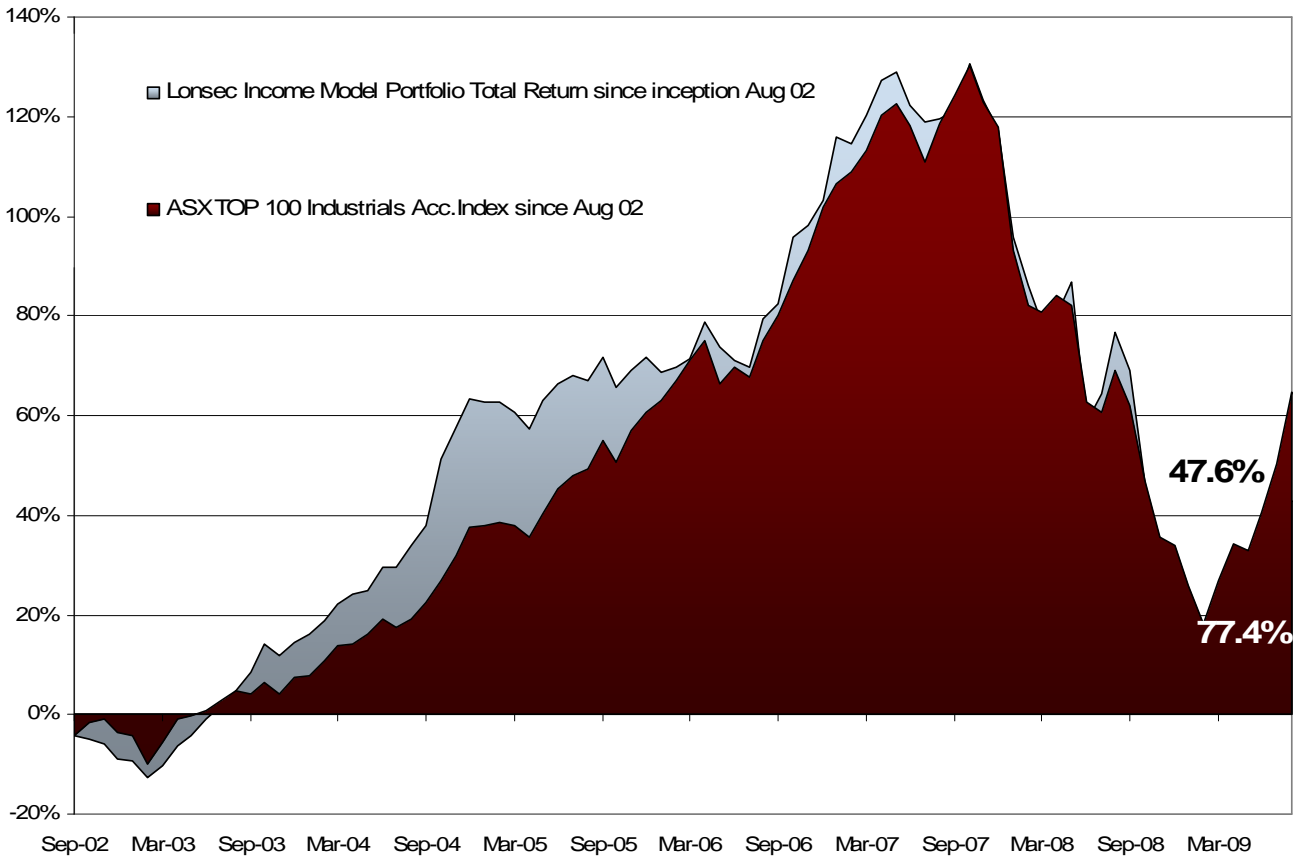
INVESTMENT PERFORMANCE				2 Years	3 Years	5 Years	7 Years	Since	
Period ending	30 September 2009	Month	Qtr	Year	% (pa)	% (pa)	% (pa)	% (pa)	Inception ¹
Lonsec Income Total Return²		3.4%	17.5%	-12.7%	-18.3%	-6.8%	1.4%	6.4%	47.6%
ASX TOP 100 Industrial Accumulation Index		7.8%	26.2%	9.5%	-11.1%	-0.5%	7.7%	9.2%	77.4%
Out/Under Performance		-4.4%	-8.7%	-22.2%	-7.2%	-6.3%	-6.3%	-2.8%	-29.8%

¹ Inception date 20 August 2002

² Investment Performance is calculated before fees, charges, brokerage and taxes. Dividends are reinvested at the end of each month.

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Portfolio Performance since inception



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