

Performance statistics – June Q11

Markets	30 Jun 2011	Qtrly % Change
All Ordinaries	4,660	-5.5%
Banks	6,027	-4.4%
Materials	13,432	-5.5%
Industrials	3,536	-6.1%
Real Estate	1,985	-2.2%
US S&P 500	1,321	-0.4%
UK FTSE 100	5,946	0.6%
Japan Nikkei	9,816	0.6%
German DAX	7,376	4.8%
Shanghai Comp	2,762	-5.7%
Hang Seng	22,398	-4.8%
RBA Cash Rate	4.75%	0bp
90 Day bill rate	4.96%	+7bp
10 year bond	5.21%	-29bp
Oil (WTI) \$US	\$95.06	-10.8%
Gold \$US	\$1,503	4.4 %



Global headwinds strengthening

The downside risks to global growth prospects seemed to increase during the June quarter.

While we remain positive on the growth outlook, increased market volatility is likely to be around for some time.

Lonsec has slightly reduced its growth asset allocation in favour of cash but investors should retain a 'buy on weakness' mentality to equities.

The global economy grew at an annualised rate of 4.3% in the 1st quarter of 2011 but growth has slowed in the 2nd quarter and downside risks seem to be increasing. The key debate in financial markets is whether the slowdown is transitory or the beginning of a deeper downturn in the global economy.

The 2nd quarter slowdown can be mostly attributed to: Japan (earthquake, tsunami, nuclear disaster); the US (higher oil prices, bad weather and supply chain disruptions emanating from Japan) and China (tightening monetary policy due to inflation concerns).

The case for a rebound in global growth includes: the US slowdown does seem genuinely due to transitory factors, which should ease in the second half; Asia's growth rate (ex-Japan) is still strong and overall monetary conditions are not overly restrictive; the core of Europe (Germany, France, Netherlands, UK) has experienced reasonably strong growth in the first half of 2011 and all seem to be in reasonable shape; interest rates are still very low in each major economy; the corporate sector seems to be in strong shape; and commodity prices are now starting to ease, in particular oil.

The downside risks to global growth, that have emerged in 2011, include:

US – the economy fails to bounce back in the 3rd quarter and/or Congress fails to come to agreement on increasing the US statutory debt ceiling which must be lifted by 2 August 2011;

Europe – Greece defaults on its debt, sparking another round of losses for the European banking system;

China – tightening policy goes on for longer than expected and the economy slows more than expected;

Japan – falls into recession in the 1st half of 2011 and fails to recover as strongly as expected;

Middle East - political turmoil in the region spills over into the large oil producing countries of Saudi Arabia, UAE, Kuwait, Iran and Iraq; and

Banking reform – new global banking regulations (Basel III) aiming to increase capital and liquidity requirements will improve the financial strength of banks, but may also limit credit growth and in turn economic growth.

On balance, Lonsec expects global growth to rebound in the second half of the year but annual growth may be a bit softer than originally expected at the beginning of the year.

In Australia, the story is similar with the economy much weaker than expected in the first half of 2011 due to flooding and cyclones in the 1st quarter but also because the economy continues to remain patchy outside of the resources sector.

Again, Lonsec expects growth to pick-up in the second half as Queensland recovers, global growth rebounds and interest rates remain on hold. The downside risks for Australia are: weaker than expected global growth, particularly in Asia, and continued weakness in the broader economy - ostensibly because of cautious consumers who appear concerned about rising costs and new taxes.

Conclusion

Overall, Lonsec believes it is prudent to reduce our growth exposure to a more neutral stance. We have reduced our International and Australian equity weightings to slightly overweight from overweight and increased our cash weighting from slightly underweight to slightly overweight. Our bond weightings remain underweight on concerns that government bond yields are too low, particularly offshore, for the apparent credit risk of the issuers. Lastly, our Australian property weighting remains at slightly overweight.

Global economic outlook

Global growth to remain robust but downside risks are increasing

The International Monetary Fund (IMF) forecasts the global economy to grow by 4.3% in 2011. Developed economies (which represent about 55% of global GDP) are expected to grow by 2.2% while developing economies (45% of global GDP) are expected to grow by 6.6%. The US and China, the two largest economies, remain the key drivers of growth.

The US economy (25% of Global GDP at market exchange rates)

The US economy slowed in the 2nd quarter to an annualised pace of around 2%. The slowdown was widely attributed to temporary factors like higher commodity prices, bad weather and supply chain disruptions emanating from the Japanese earthquake. New payrolls have fallen from around 200,000 per month, earlier in the year, to under 20,000 per month by mid-year whilst the unemployment rate has ticked back up to 9.2% from its April low of 8.8%. The housing market remains depressed with house prices down around 30% since 2007, while housing activity remains subdued. Manufacturing surveys remain in expansionary territory but have declined from the 60 level to around 54 by June (above 50 indicates expansion).

On the positive side, growth is expected to rebound in the second half of 2011 and is being led by exports, investment and retail sales. The US is making gradual progress on withdrawing from Iraq and Afghanistan ahead of the US federal election next year. In addition, congress is being forced to address reining in the US budget deficit with the government about to breach its own statutory debt limit by early August 2011. Interest rates remain very low and the Federal Reserve has had enough confidence in the economy to wind back its debt purchasing program. The IMF forecasts the US economy to grow by 2.5% in 2011, down from 2.9% in 2010.

The European economy including the UK (22% of Global GDP)

Greece was the centre of attention in the June quarter with the government having to approve fairly severe austerity measures to receive funding from the European Union and the IMF. Greece is only a small economy but it has €340bn in outstanding public debt which is held by various European banks and other financial institutions. If Greece defaults on its debt, it will lead to another round of losses for the European financial system and could also spark fears that other indebted countries, like Ireland and Portugal, will follow next. A greater concern would be if the larger economies of Spain and Italy start to become entangled in the sovereign debt crisis.

The positive news is that the core of Europe (Germany, France, Netherlands, UK) is experiencing reasonable growth. So much so that the ECB has started lifting interest rates, albeit from fairly low levels (the ECB cash rate is 1.50%). Nevertheless, the banking system of these larger countries has significant exposure to the problem states of Europe, so the strength of the European Union will continue to be thoroughly tested in the short to medium term. The IMF expects the European economy to grow by 2.0% and the UK economy to grow by 1.5%, in 2011.

The Asian economy (22% of Global GDP)

Asia (ex-Japan) is maintaining its strong growth momentum but rising inflation is leading to tightening monetary policy in China and India and more broadly across emerging Asia. Recognising its increased scale and developing status, China has lowered its medium term growth target to 7-8% and its intention to rebalance the economy away from exports & investment towards consumption by improving income distribution across the economy.

The earthquake, tsunami and nuclear disaster in the north-east region of Japan have sent the Japanese economy into recession in the first half of 2011. However, a \$200-300bn rebuilding program is expected to boost growth in subsequent quarters. Japan is still the world's third largest economy (after the US and China) and has strong capital and trade links with the rest of the world, so investors need to monitor its recovery progress closely. The IMF forecasts the Chinese economy to grow by 9.6%, India to grow by 8.2% and Japan to shrink by 0.7% in 2011.

Key global issues to watch	Lonsec view
US economic growth	US slowdown should be temporary; the economy should rebound in the second half of 2011.
Chinese economic growth	Growth likely to slow to around 8-9%, to contain inflationary pressure, but is still relatively robust.
Japan natural disaster	Japan to enter recession in 1H11 but should experience a cyclical recovery in 2H11. The BOJ is likely to increase its asset purchasing program to help the government finance reconstruction.
Inflation	Not yet a problem in the developed world but developing economies will need to tighten fiscal and monetary policy, allow appreciation of their currencies and lower growth rates.
European debt crisis	Core of Europe okay but weak southern states could cause another financial crisis in the European region. Europe remains a key downside risk for global growth.

Domestic economic outlook

Natural disasters and cautious consumers to slow growth and keep interest rates on hold in 2011

The Australian economy contracted by -1.2% in the first quarter of 2011 due mainly to the impact of flooding and cyclones. Annual growth has fallen to just 1% but it is widely expected to rebound throughout 2011. However, outside of the mining sector, economic data since the first quarter has been quite soft which suggests the economy may post below trend growth this year.

Household spending and housing activity has been quite soft and is expected to remain so for most of 2011. It seems households are now saving more and borrowing less, post the GFC. This has led to Australia being described as a 'two-speed economy' with the export sector strong and the household sector weak. This is generally true but government spending has also been a major swing factor in recent years.

Moving forward, Lonsec expects the export sector and government spending (flood rebuilding) to remain major growth drivers. Over the medium term, business investment should also gain momentum based on business capital expenditure plans. The key area of uncertainty remains household spending and housing activity. If interest rates remain at current levels (or move higher) and household living costs continue to rise, consumption growth could remain weak in the short term.

Lonsec believes the RBA is highly likely to keep the cash rate on hold for 2011 given growth is likely to miss expectations and monetary policy is already "mildly restrictive" according to the RBA's own view.

Despite the expected short term dip in growth, the fundamentals of the Australian economy remain sound and the medium to long term outlook remains strong. If there are any short term hiccups in the global growth story, Australia has room to cut interest rates which is a luxury that many developed economies no longer have. Australia's economic growth is now highly leveraged to growth in emerging Asia and hence the economic cycle in these countries is now the key risk for the Australian economy.

Lonsec expects Australia's annual growth rate to dip to 2.3-2.5% in 2011 and then recover to around 3.0% in 2012. This is based on the assumption that the Asian growth story continues and interest rates remain on hold in 2011.

Key negatives/risks:

- **Reliance on Asian exports** – any cyclical slowdown in Asia would negatively affect commodity prices and export volumes which would have a material negative impact on the Australian economy;
- **Regulatory risk** - the minority Labor Government seems increasingly frustrated with its progress and is becoming more desperate to implement policy as the States gradually transition back to Liberal/National government. Policies such as a Mineral tax, a Carbon tax and a Flood levy pose various risks for business and consumer confidence;
- **Increased capital requirements for banks** – Australian banks are seeking to increase their capital base and liquidity in response to the post GFC environment but also because of global banking reform (Basel III). As a result they are generally seeking to increase deposits and lower growth in lending;
- **Inflation** – after 20 years of continuous growth, capacity constraints and loss of productivity could lead to cost-push inflation which would require higher interest rates to contain; and
- **Housing bubble?** – there has been much talk about the Australian housing market being overvalued. Any material decrease in house prices would reduce household wealth and impair bank assets.

Key local issues	Lonsec view
Cash rate	RBA to remain on hold for 2011.
Inflation	Underlying inflation should remain within the RBA's target range of 2-3% in the short term.
AUD/USD	AUD to remain strong in 2011 but the USD should rally in 2012 as US monetary policy is tightened.
Commodity prices	Rising demand from developing economies and supply bottlenecks should sustain high commodity prices in the short to medium term.
Housing bubble?	There has been much talk about the Australian housing market being overvalued. This could be true on some measurements but does not necessarily mean prices will fall – they could remain stable in the short to medium term given low unemployment, rising incomes, low loan default rates, population growth and undersupply issues.
Government policy	Policy regarding a mineral tax, a carbon tax, pokie reform, banking reform, financial services reform, healthcare reform, industrial relations and telco reform are causing headaches for business. There is a risk that the government's agenda hurts confidence and the economy underperforms in the next 2 years.

Recommended Tactical Asset Allocation

Lonsec retains an optimistic view on global growth but recognises that the downside risks seem to be increasing. In response, we have slightly reduced our allocation to growth assets in favour of cash. Our bond weightings remain underweight because we believe the yields on most major international government bonds do not reward investors for the apparent risks of the sovereign issuers while in Australia, cash and fixed term deposits remain an attractive option relative to government bonds. We expect periods of market volatility to continue, given the numerous issues across the globe, but we would view such periods as opportunities to buy quality stocks for the long term.

Investment Category	Asset Class	June Qtr 2011	Sept Qtr 2011
Income	Cash	Slightly Underweight	Slightly Overweight
Income	Australian Fixed Interest	Underweight	Underweight
Income	International Fixed Interest	Underweight	Underweight
Growth	Australian Property (A-REITS)	Slightly Overweight	Slightly Overweight
Growth	Australian Equities	Overweight	Slightly Overweight
Growth	International Equities (Unhedged)	Overweight	Slightly Overweight

Cash – Increased to Slightly Overweight

Australia has one of the highest cash rates in the developed world at 4.75%. Fixed term deposit rates are also relatively attractive as banks are seeking to increase their deposit to loan ratios in the post-GFC environment. The RBA has maintained the cash rate at 4.75% since November 2010 and it views monetary policy as ‘mildly restrictive’. With growth expected to rebound during 2011, the RBA retains a tightening bias but expectations for the next rate rise have been delayed into 2012 given the patchy performance of the economy to date. Overall, cash and fixed term deposits remain attractive relative to bonds, while the RBA retains a tightening bias.

Australian fixed interest – Underweight

The Australian yield curve offers better value than most major debt markets with the cash rate at 4.75% and the 10-year bond yield at 5.0%. However, inflation is also higher in Australia at 2.4% and the expectation is that inflation will rise in the short to medium term. In addition, we expect global bond yields to move higher from here which will also influence our market. As a result, Lonsec expects the Australian yield curve to move higher during 2011 hence bond prices may have more downside. That said, we see reasonable value in Australia and are more likely to move to neutral on Australian fixed interest than International fixed interest, if the yield curve does indeed move higher during 2011.

International fixed interest – Underweight

Lonsec finds the investment case for global bonds to be unattractive as yields range from 1.2% to 3.6% on most major global 10-year bond issues. The return seems inadequate given the size of the budget deficits and public debt levels of the major issuers. Lonsec notes that G20 countries have pledged to cut their budget deficits in half by 2013 but this is still a long way from generating a surplus and actually reducing public debt burdens.

Investors would only find global bonds attractive if they believe the global economy is in for a lengthy period (5 years+) of deflation, which is not Lonsec’s base-case scenario. We expect rising bond yields (and hence falling bond prices) as the growth outlook improves, inflation re-emerges and central banks reduce their bond purchasing programs.

Australian listed property (A-REITs) – Slightly Overweight

The A-REIT sector is dominated by the top ten trusts, which have all recapitalised and are now financially stable. From here, the focus will be on where capitalisation rates settle for each sector and future distribution growth. Lonsec believes the A-REIT sector will be more ‘plain-vanilla’ from now on, meaning trusts will revert back to offering relatively high yield (compared to bonds) with modest capital growth, over the long term.

Lonsec continues to prefer domestic REITs over global REITs, due to the better economic fundamentals of Australia and the more advanced recapitalisation process. The AREIT sector has recently moved down to the lower bound of its two year 840-900 trading range and looks to offer reasonable value again. We remain slightly overweight but we expect the sector to rally later in the cycle than equities.

Australian equities – Reduced to Slightly Overweight

The Australian market gained 8% over the year to 30 June 2011 which was a reasonable result but was well below the S&P500 return of 28%. For nearly two years now, the Australian market has been stuck in a trading range of 4,400 – 5,000. In Lonsec's view this can be attributed to: a rising AUD (up 27% in FY11), government policy regarding new taxes (Carbon tax, Mineral tax, Flood levy), tightening monetary policy in Australia and a spate of natural disasters earlier in the year.

The economy is expected to remain quite soft in the first half of 2011 but should gain momentum in the second half of the year assuming Queensland recovers, interest rates remain on hold and global growth remains robust. The fundamentals of the Australian economy and most listed companies remain sound in terms of balance sheet strength and medium to long term growth prospects. In addition, valuations on the ASX are now quite reasonable at around 10-12x FY12 earnings relative to historical norms of around 14x forward earnings:

Sector	Market weight	FY11 PER*	FY12 PER*
Resources & Energy	37%	14.2x	10.3x
Financials	28%	11.4x	10.2x
Industrials	28%	14.1x	12.2x

*average of major broker estimates, 30 June 2011

So the market looks good value if the global recovery continues and the domestic economy gains momentum throughout the year. New government taxes (Mineral tax, Carbon tax) remain a key risk to be wary of but are not expected to adversely impact overall economic growth - although some industries may be impacted more harshly than others.

Lonsec's comments on the broad sectors of the market follow:

Resources and Energy – Australian resource and energy stocks should benefit from rising commodity prices and firm demand from Asia. The strong AUD and new taxes will negate some of the upside but the net benefit should still be substantial. The sector looks fairly cheap at the moment. The major risks to be aware of are: lost production due to recent flooding, government policy regarding the Mineral and Carbon tax, any slowdown in Asia, infrastructure bottlenecks and rising operating costs.

Financials – the Australian banking sector is now dominated by the four major banks that rank in the top 10 of global banks in terms of capital strength. They are currently experiencing a rising cost of capital but in reality margins are still healthy and ROE is still high at around 15%. Moving forward, any rally in the share market will improve wealth management earnings and credit growth is expected to recover over the medium term. Lonsec prefers the banks over the insurers as insurers are suffering from 'abnormal' claim experiences which seem to be becoming normal due to regular climate-change-related events. The major risks to be aware of are: the cost of capital, financial market volatility, regulatory change and the general level of credit growth.

Industrials – the industrial sector looks to offer less value at the moment relative to the resources and financial sectors but there are still some roses among the thorns. Lonsec prefers the chemicals, engineering, healthcare, consumer staple retailing and food & beverage industries within the sector. Many of the companies have high operating leverage to the domestic economy meaning a small pick up in growth translates into a major increase in revenue and earnings. The major risks to be aware of are: the impact of a rising AUD, patchy growth across the economy, the impact of the Carbon tax and regulatory reform.

International equities (unhedged) – Reduced to Slightly Overweight

As mentioned above, the S&P500 gained 28% in the last financial year but a 27% rise in the AUD/USD took away most of the upside for unhedged investors. Moving forward the US economy is going through a soft patch but is expected to gain momentum in the second half of the year. US companies are in great shape and valuations still remain reasonable at around 13.6x 2011 forecast earnings and 12.0x 2012 forecast earnings. Global equities (ex-US) also seem reasonably priced at around 12.4x 2011 forecast earnings and 10.9x 2012 forecast earnings.

The AUD/USD is currently trading around 1.07 and it is hard to see the AUD rallying in FY12 as much as it did in FY11 (a gain of 27% from this level would take the AUD/USD to \$1.36!). With monetary policy seemingly on hold in Australia, it is likely the currency will be more contained in the short term.

Overall, Lonsec remains of the view that Australian investors should be using the relatively strong AUD to consider increasing their international equity positions. That said, the US market has had a strong run since its March 2009 low, so it would be wise to wait for periods of weakness before acting on this view.

Lonsec Direct Model Portfolios

Investment Philosophy

Lonsec focuses on generating strong returns above benchmark, over the medium to long term, through concentrated, low-turnover portfolios.

Investment Process



Australian Equity Core Model 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.

Portfolio Rules

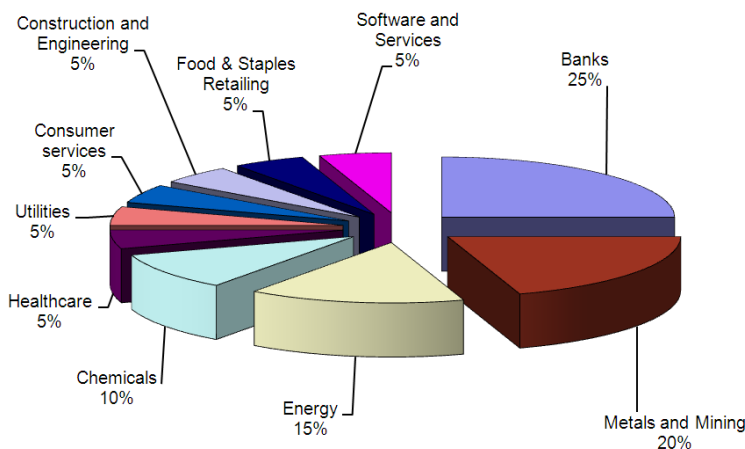
Investment universe	ASX 150 excluding A-REITs
Benchmark	S&P/ASX 100 Accumulation Index
Inception date	17 April 2000
Min/Max no. of stocks	12 - 20
Typical number of stocks	15
Min. no. of GICS industries	8
Maximum stock target weight	15%
Stocks weighted at 10% or more must be selected from ASX 50	
At least 80% of the portfolio must be invested in the ASX 100	
Average turnover	20-30% pa

Portfolio Profile

PORTFOLIO BY GICS INDUSTRY	Weight
Banks	25%
Metals and Mining	20%
Energy	15%
Chemicals	10%
Healthcare	5%
Utilities	5%
Consumer services	5%
Construction and Engineering	5%
Food & Staples Retailing	5%
Software and Services	5%
Total	100%

PORTFOLIO BY MARKET CAP RANKING	Weight
ASX 50	90%
ASX 51-100	10%
ASX 101-150	0%
Total	100%

Core Portfolio by GICS Industry



Portfolio Performance

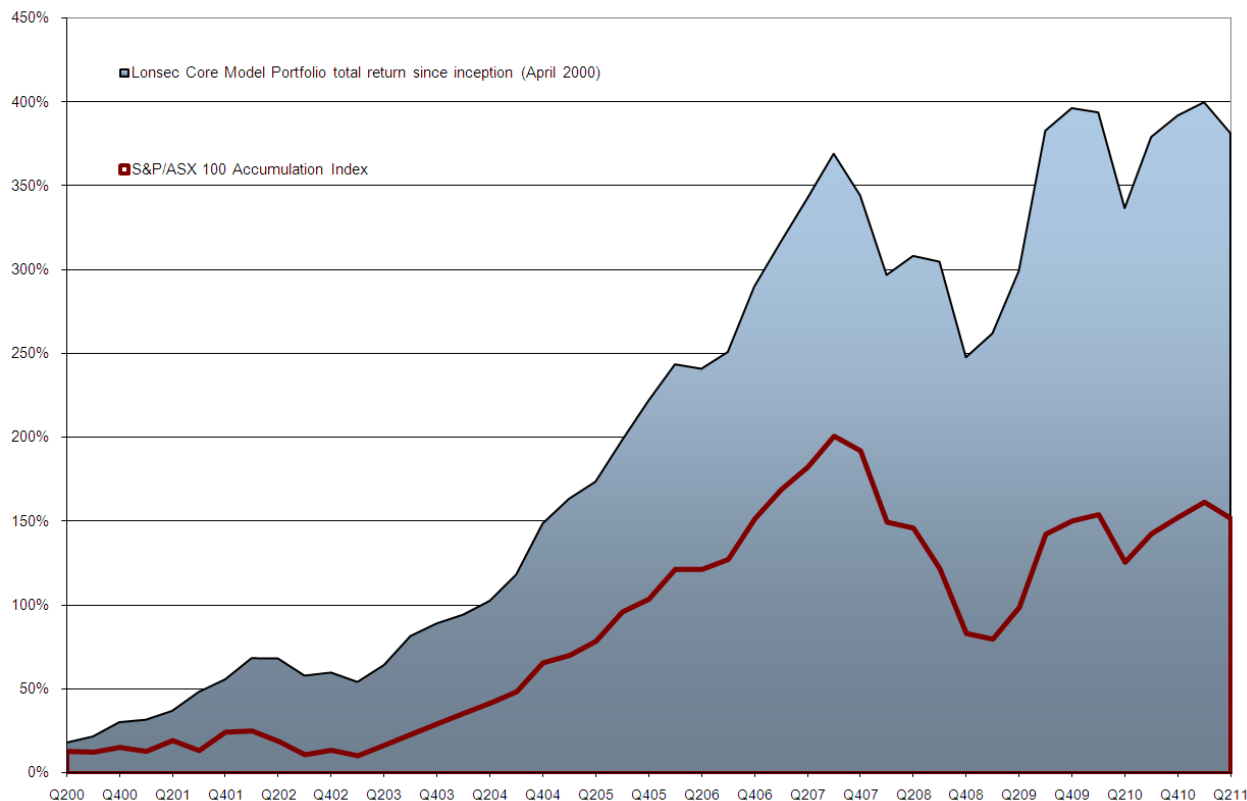
INVESTMENT PERFORMANCE													Since	Since
Period ending	30 June 2011											Inception ¹	Inception ²	
	Month	Qtr	Year	2 Yrs ¹	3 Yrs ¹	4 Yrs ¹	5 Yrs ¹	7 Yrs ¹	8 Yrs ¹	9 Yrs ¹	10 Yrs ¹			
Lonsec Core Model Total Return ³ (%)	-1.5	-3.7	10.2	9.7	5.6	2.1	7.1	13.1	14.4	12.4	13.4	15.0	381.1	
S&P/ASX 100 Accumulation Index (%)	-1.7	-3.7	11.5	12.5	0.8	-2.8	2.6	8.5	10.1	8.6	7.7	8.6	151.7	
Excess return (%)	0.2	0.0	-1.3	-2.8	4.8	4.9	4.5	4.6	4.3	3.8	5.7	6.4	229.4	
Portfolio excess return (alpha) since inception (% p.a.)	6.4		Portfolio volatility since inception (%)					13.8						
Portfolio tracking error since inception	6.9		Benchmark volatility since inception (%)					14.7						

¹ % per annum ² Total return since inception date 17 April 2000

³ 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.



Australian Equity Income Model Portfolio

Objective

To deliver an attractive fully franked income yield and reasonable capital growth, over the medium to long term.

Portfolio Rules

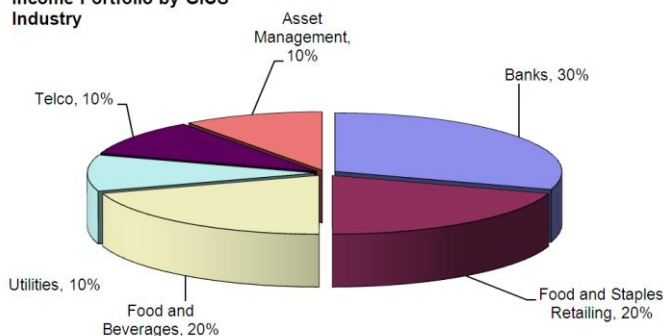
Investment universe	ASX 150 excluding A-REITs
Benchmark	S&P/ASX 100 Industrial Accumulation Index
Inception date	20 August 2002
Min/Max no. of stocks	10 – 20
Min. no. of GICS industries	6
Individual stock target weights	10%
Companies must pay, or intend to pay, fully franked dividends	
At least 80% of the portfolio must be invested in the ASX 100	
Typical number of stocks	10
Typical portfolio weights	10 x 10%
Average turnover	20-30% pa

Portfolio Profile

PORTFOLIO BY GICS INDUSTRY	Weight
Banks	30%
Food and Staples Retailing	20%
Food and Beverages	20%
Utilities	10%
Telecommunications	10%
Asset Management	10%
Total	100%

PORTFOLIO BY MARKET CAP RANKING	Weight
ASX 50	90%
ASX 51-100	10%
ASX 101-150	0%
Total	100%

Income Portfolio by GICS Industry



Portfolio Performance

INVESTMENT PERFORMANCE												Since	Since
Period ending	30 June 2011	Month	Qtr	Year	2 Yrs ¹	3 Yrs ¹	4 Yrs ¹	5 Yrs ¹	6 Yrs ¹	7 Yrs ¹	8 Yrs ¹	Inception ¹	Inception ²
Lonsec Income Total Return³ (%)		0.9	-0.6	8.9	14.7	1.4	-7.1	-0.7	-0.1	3.6	6.6	6.4	65.3
S&P/ASX 100 Industrial Accumulation Index (%)		-0.8	-2.4	8.7	11.7	2.6	-5.3	0.7	3.2	5.7	7.2	7.2	75.6
Excess return (%)		1.7	1.8	0.2	3.0	-1.2	-1.8	-1.4	-3.3	-2.1	-0.6	-0.8	-10.3

¹ % pa ² % total return (excluding franking credits) since inception 20 August 2002

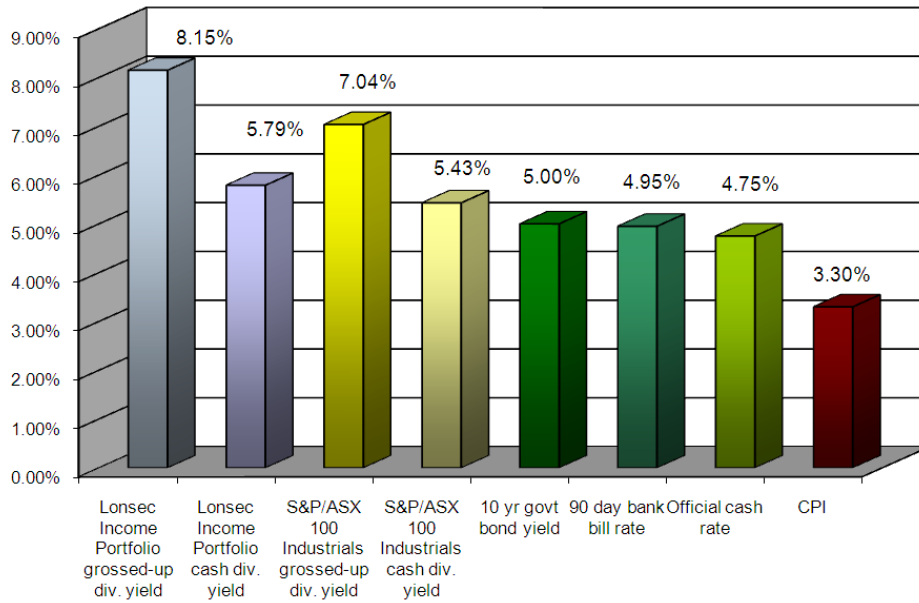
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Portfolio Yield

Current Income Portfolio Yield v Various Benchmarks



Note: grossed-up dividend yield includes the value of franking credits

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