fatPROPHETS™ 1300 881 177

SIGNATURE DISH RECOMMENDATIONS, Fat 210

22/12/2004 **FAT-AUS-210**

Signature dish recommendations, as the name suggests, represent stocks that fit the staple Fat Prophets diet. These stocks are mostly medium to large capitalised stocks that are valued on low price earnings multiples, supplemented by a healthy dividend yield. Over 2004, all but one Signature dish sell recommendation achieved a profit.

The steel industry has prospered over the last couple of years, as suppliers struggled to keep up with global demand. In particular, the booming Chinese construction industry fuelled worldwide increases in steel and scrap metal prices. In 2004, we had mixed success with our steel related stocks, one posting a healthy profit and the other a small loss. With early signs of an impending correction in steel and scrap prices, we reduced our exposure to the industry.

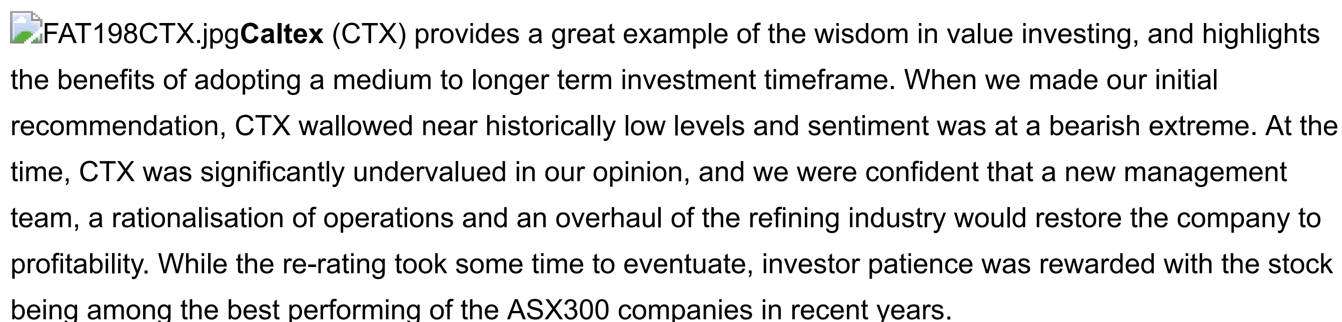
FAT183SMS.jpgSydney based **Sims Group** (SMS) is one of the world's largest scrap metal recyclers, and the company offers investors absolute leverage to global scrap prices. Sims was a respectable performer during its time within the Fat Prophets Portfolio, more than doubling in price while paying a regular dividend stream. When initially recommended, the stock was decidedly out of favour with investors trading near eight year lows. However, sentiment eventually improved and the stock became a market favourite. The time to be reaching for the umbrella is when there are no clouds in the sky, and given it was our belief that all the good news was priced-in, we quietly exited the stock taking some healthy profits.

FAT187SSX.jpg**Smorgon Steel** (SSX), on the other hand, has been the perennial under performer in the Australian steel industry, despite the buoyancy of the local construction sector. At a time when domestic peers had been making robust profits, SSX consistently found excuses for under performing. While our support for SSX was based on a cheap valuation, we no longer held confidence in management's ability to turn the company around. At the time of our sell recommendation we were not only concerned about a pullback in steel prices but also the potential threat of increased competition from low priced Asian steel importers. While taking a loss is never pleasant, we were of the opinion better opportunities existed elsewhere. The one consolation was the consistent dividend stream. Including distributions, the overall result was reduced to a loss of 5.8 percent.

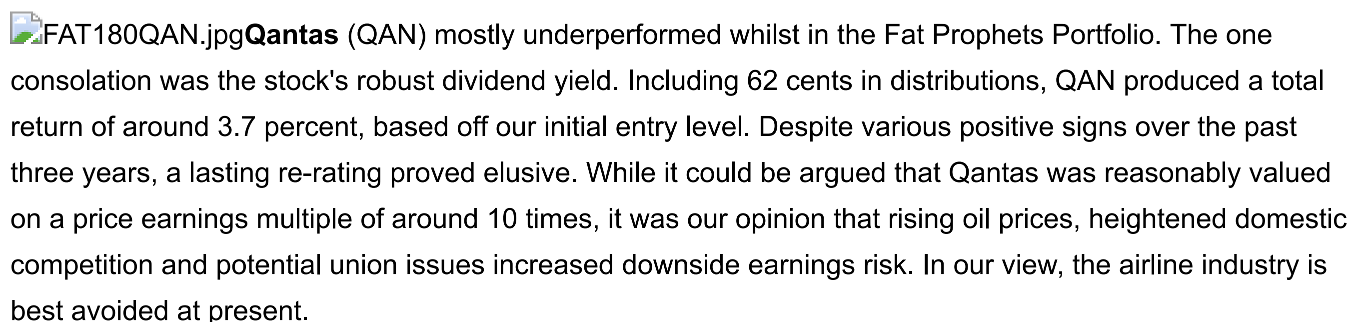
FAT202MCC.jpgWith steel in huge demand, it was only a matter of time before coal producers reaped some of the benefits. Coal is widely used to power the plants that produce steel. **Macarthur Coal** (MCC) was a classic signature dish in our opinion, trading on low price to earnings multiple with excellent growth prospects. During 2004 MCC transformed into a two mine company, and as coal prices rose, so too did profitability. While the valuation remained reasonable, we were nevertheless wary of the meteoric rise in the

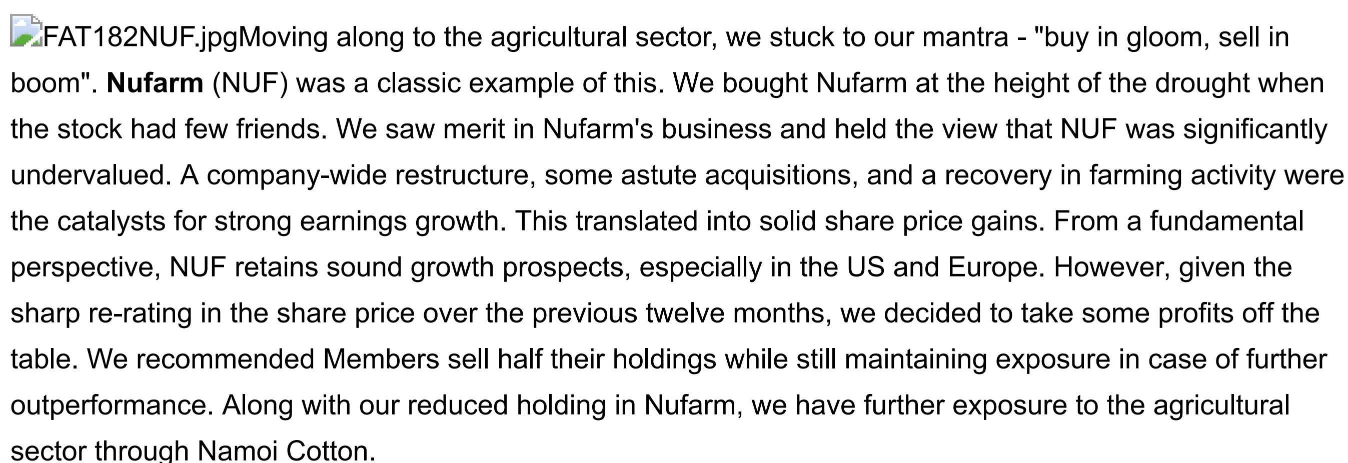
share price. MCC had more than trebled over the previous twelve months which increased the risk of a correction. Taking advantage of historically high prices, we recommended Members sell half their holdings.

Like the coal industry, the oil sector also heated up over the course of 2004, and we continue to hold our favoured exposures in Woodside and Oil Search. We believe these companies will continue to prosper. Two oil sensitive stocks that we did choose to reduce exposure to over the course of the year were Caltex and Qantas, both for differing reasons.

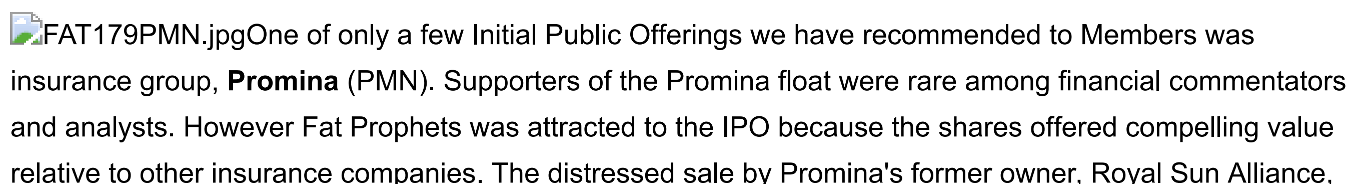

FAT198CTX.jpg**Caltex** (CTX) provides a great example of the wisdom in value investing, and highlights the benefits of adopting a medium to longer term investment timeframe. When we made our initial recommendation, CTX wallowed near historically low levels and sentiment was at a bearish extreme. At the time, CTX was significantly undervalued in our opinion, and we were confident that a new management team, a rationalisation of operations and an overhaul of the refining industry would restore the company to profitability. While the re-rating took some time to eventuate, investor patience was rewarded with the stock being among the best performing of the ASX300 companies in recent years.

At the time of our sell recommendations, Caltex remained in an uptrend, but we were mindful of the fact that the stock was becoming very expensive. The bull trend also appeared to be approaching maturity. We recommended Members sell half their holdings in April, and this was followed by a further sell half in September. Some exposure has been maintained in the event of further out performance.

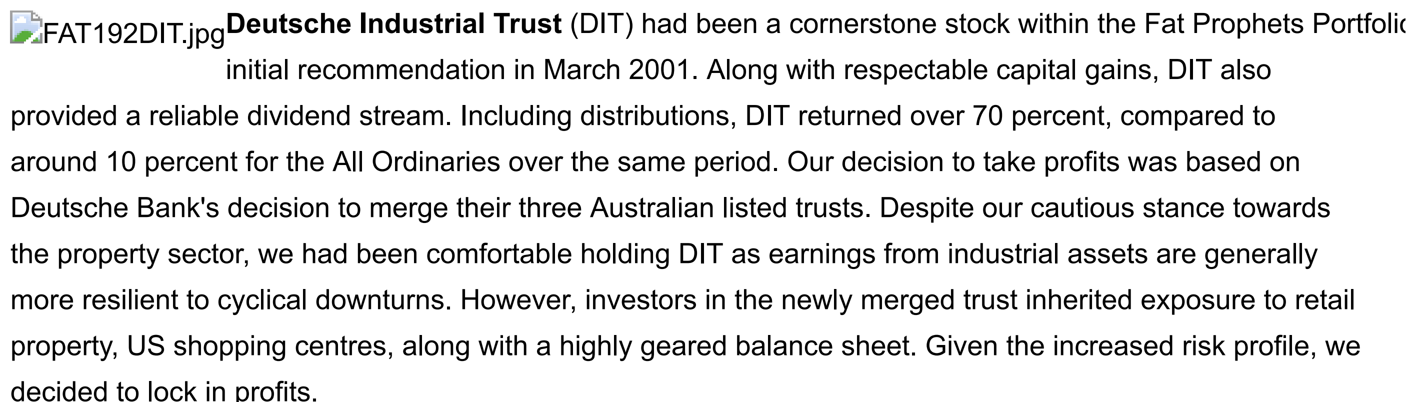

FAT180QAN.jpg**Qantas** (QAN) mostly underperformed whilst in the Fat Prophets Portfolio. The one consolation was the stock's robust dividend yield. Including 62 cents in distributions, QAN produced a total return of around 3.7 percent, based off our initial entry level. Despite various positive signs over the past three years, a lasting re-rating proved elusive. While it could be argued that Qantas was reasonably valued on a price earnings multiple of around 10 times, it was our opinion that rising oil prices, heightened domestic competition and potential union issues increased downside earnings risk. In our view, the airline industry is best avoided at present.


FAT182NUF.jpgMoving along to the agricultural sector, we stuck to our mantra - "buy in gloom, sell in boom". **Nufarm** (NUF) was a classic example of this. We bought Nufarm at the height of the drought when the stock had few friends. We saw merit in Nufarm's business and held the view that NUF was significantly undervalued. A company-wide restructure, some astute acquisitions, and a recovery in farming activity were the catalysts for strong earnings growth. This translated into solid share price gains. From a fundamental perspective, NUF retains sound growth prospects, especially in the US and Europe. However, given the sharp re-rating in the share price over the previous twelve months, we decided to take some profits off the table. We recommended Members sell half their holdings while still maintaining exposure in case of further outperformance. Along with our reduced holding in Nufarm, we have further exposure to the agricultural sector through Namoi Cotton.

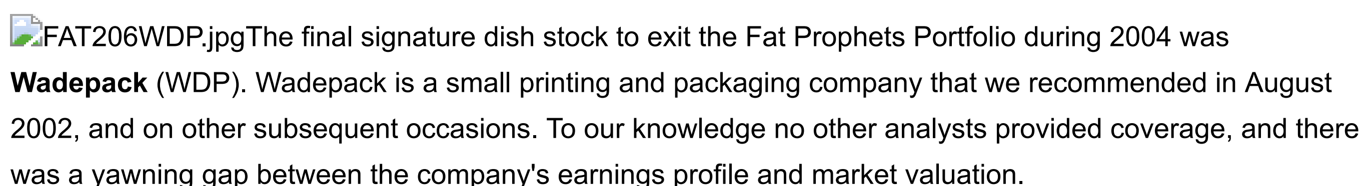
In the financial services sector, Fat Prophets have avoided bank stocks. Throughout 2003, we became increasingly wary of the negative impact of rising interest rates on bank profitability. Nevertheless, insurance companies continued to deliver robust returns on the back of buoyant premiums, and low claim ratios.


FAT179PMN.jpgOne of only a few Initial Public Offerings we have recommended to Members was insurance group, **Promina** (PMN). Supporters of the Promina float were rare among financial commentators and analysts. However Fat Prophets was attracted to the IPO because the shares offered compelling value relative to other insurance companies. The distressed sale by Promina's former owner, Royal Sun Alliance,

opened a rare buying opportunity where a quality asset could be acquired for a very cheap price. Promina experienced strong out performance following the successful listing which pushed the insurer's valuation back into line with its peers. We recommended Members sell Promina when the shares appeared to us fully priced. We still retain exposure to the sector through QBE Insurance.



Deutsche Industrial Trust (DIT) had been a cornerstone stock within the Fat Prophets Portfolio initial recommendation in March 2001. Along with respectable capital gains, DIT also provided a reliable dividend stream. Including distributions, DIT returned over 70 percent, compared to around 10 percent for the All Ordinaries over the same period. Our decision to take profits was based on Deutsche Bank's decision to merge their three Australian listed trusts. Despite our cautious stance towards the property sector, we had been comfortable holding DIT as earnings from industrial assets are generally more resilient to cyclical downturns. However, investors in the newly merged trust inherited exposure to retail property, US shopping centres, along with a highly geared balance sheet. Given the increased risk profile, we decided to lock in profits.



The final signature dish stock to exit the Fat Prophets Portfolio during 2004 was **Wadepack** (WDP). Wadepack is a small printing and packaging company that we recommended in August 2002, and on other subsequent occasions. To our knowledge no other analysts provided coverage, and there was a yawning gap between the company's earnings profile and market valuation.

WDP produced solid results whilst in the Fat Prophets Portfolio, culminating in a takeover offer from Carter Halt Harvey in November. The Board of Wadepack unanimously recommended shareholders accept the offer. With little chance of a counter offer from a third party, we recommended Members take the opportunity to exit their investment with a healthy profit.

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