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Companies Announcements Office
ASX Limited
20 Bridge Street
Sydney New South Wales 2000

ASX Release – Investment Mandate Update

1. Overview

- Subject to Shareholder's approval, Fat Prophets Australia Fund Limited (**Fund**) will be renamed and be known as the Merricks Capital Special Opportunity Fund.
- The Fund will focus on having between 3 to 10 investments at any given time.
- Generally the Fund will focus on making investments with small to mid-cap Australian listed companies.
- The types of investments that the Fund will target are:
 - Obtaining a strategic stake in a desired small to medium sized listed company via placement of new securities or acquisition of securities.
 - Construction of unlisted convertible securities offering equity-type returns but with debt security characteristics.
 - Combining with other investors to acquire significant stakes in companies with a view to actively agitating for change, which could release hidden value to all shareholders.
 - Investments that reward the provision of liquidity.
- The Fund's core strength is that it has semi-permanent capital.
- The Fund will have the ability to use leverage and if appropriate may hedge positions.
- The Fund will seek to make investments that will allow the Fund to pay regular and consistent dividends.
- The Fund will be able to target sectors of the market where there is a shortage of competitors.
- The Fund will also have the ability to co-invest in opportunities with Merricks Capital's other funds.
- Please find attached as Appendix A the investment mandate approved by the Fund's Board.

2. Comments by Andrew Brown, the Fund's Independent Chairman

2.1. Recent history of the LIC sector

- To provide a reasoned assessment of why the Independent Directors of the Fund believed it is desirable to amend the prior mandate of the Fund and approve the change of Manager, it is worthwhile to provide some historical perspective of the changing nature of the Australian Listed Investment Company (**LIC**) arena.
- The origins of the LIC sector can be traced back to the late 1920's with the listing of the predecessor of Australian Foundation Investment Company, followed in the late 1940's with the listing of Argo Investments and the 1958 floatation of Milton Corporation. These old established LIC's are characterised by five main features:
 - They are internally managed by a small group of employee executives, overseen by a group of Directors, usually via an investment committee.
 - They are now large in scale and consequently have very low fixed operating costs relative to assets managed.
 - They effectively have no variable costs since there is no external management agreement.
 - They have active, though benchmark aware positions (i.e investments are made cognisant of weighting in an underlying index such as the S&P/ASX 300) but are passively managed in that the portfolio, other than a small portion, is not actively traded due to the underlying philosophies of each company in generating income through dividends; in turn, this has beneficial taxation consequences enabling the pass-through of the 50% capital gains tax discount directly to shareholders for positions sold, but held over twelve months.
 - They have large franking account balances and accumulated profits which have enabled the regular payment of dividends to shareholders, through virtually all down-cycles.
- These features mean that the "old established" LIC's represent an extremely viable alternative to externally managed Australian equity unit trusts (or open ended funds). However, this has led to a drawback for certain older LIC's insofar as their shares have tended to trade at premiums to prevailing net asset backing per share ("NTA/share") on the secondary market. This premium has usually reflected the ability to maintain dividend rates and has resulted in pricing on a "yield" basis.
- Many recent attempts to establish externally managed alternatives to these companies, starting in the 1980's with the rise of the "name brand" professional fund managers, have failed to succeed. In some cases, the companies were mere adjuncts to the funds management business itself, and comprised a portfolio of securities which could have been acquired through alternative open-ended structures. In the open-ended structure, the investor received the direct benefit of the portfolio itself, rather than the portfolio plus or minus changes in discount to NTA/share. Other attempts to establish more esoteric vehicles, investing in overseas markets, foundered on lack of track record or adverse taxation consequences.
- A "new breed" of Australian equity LIC's emerged in the 2003-2005 period. These LIC's sought to provide retail investors with an exposure to "boutique" investment managers, whose skills were only available to institutional or wholesale investors. Unfortunately many, though not all, of these LIC's have been characterised by high management

expense ratios, benchmark aware portfolio management, moderate performance and eventual shareholder disillusionment. Further, a number of these LIC's were unable to pay dividends during the 2008-9 global equity downturn due to an absence of accrued profits, although recent changes to Corporations Act legislation will make this possible in future.

- Furthermore, these newer LIC's are increasingly becoming an unviable competitor to lower cost unit trusts, individually managed account or index fund/ETF structures, especially if managed in a "benchmark aware" manner. As a consequence, they are tending to trade at more permanent discounts to NTA/share, reflecting the net present value cost of long term external investment management contracts; the opening up of significant discounts to NTA/share in the 2007-2009 downturn has not been recouped.
- Given this situation, these LIC's have been subject to increasing corporate actions through orchestrated attempts to acquire board control, and/or repatriate capital to investors. In many cases, of course, investors are happy to have their capital returned, rather than see their invested dollar trade at 75-85 cents.

2.2. Using permanent capital: providing a possible alternative to NTA discounts

- In the view of the Independent Directors of the Fund, there are alternatives to this miserable situation. The Independent Directors believe that such alternatives revolve around acknowledging the most critical, but often unrespected, attribute of an LIC – the permanency of its capital.
- Certain investment structures do not require permanent capital since the underlying investments are highly liquid, and can be readily sold at prices proximate to the prevailing market. Top 100 shares in Australia clearly fit this bill, and there is no reason why capital placed into structures investing in such securities cannot be of a redeemable nature. Conversely, of course, Australia was for years one of the few countries which permitted redeemable (or open ended) capital structures to invest in real estate – with dire consequences in the late 1980's and early 1990's. A classic maturity mismatch of "borrow short, lend long" unfortunately repeated in many mortgage funds in the first decade of the new millennium.
- In addition, the Independent Directors of the Fund believe that a capital pool of approximately \$30million has a real value; to replace it would require significant expense in prospectus preparation and distribution. Hence, to simply return capital to shareholders without exploiting sensibly thought out alternatives is, in the Directors' view, a sub-optimal outcome.
- Hence, the Independent Directors have sought to establish with Merricks Capital a new investment mandate which explicitly capitalises on the permanency (or closed end nature) of the capital, whilst seeking to ensure that Fund securities will not trade at a significant discount to NTA/share.
- To fulfil these twin objectives meant that the Independent Directors sought to ensure the Fund has a manager with a skill set in areas other than just Australian equities.
- The new mandate aims to earn an above average return from a smaller concentrated portfolio of investments, by supplying the Fund's capital in a different manner to a simple "passive" benchmark aware equity portfolio. These concentrated investments will comprise situations such as:
 - Supply of our capital via placement of new securities providing a strategic stake in a desired small to medium sized listed company;

- Construction of unlisted convertible securities offering equity-type returns but with debt security characteristics; and
 - Combining with other investors to acquire significant stakes in investee companies with a view to actively agitating for change, which could release hidden value to all shareholders.
- Such a mandate will, of course, be benchmark unaware (i.e investments are made irrespective of weighting in an underlying index such as the S&P/ASX 300) and may result in either the portfolio being significantly invested in cash – if there are few apparent investments of this nature available. Alternatively, the Fund may be geared if there are genuinely attractive opportunities justifying, for instance, the credit spread between the Fund's cost of debt and the return available for effectively on-lending to an investee.
 - This aspect of the new mandate highlights the fact that the Directors – and manager – of the Fund must be highly cognisant of the Fund's own cost of capital; in the future. The effective return from these opportunities will be heavily diluted if the Fund's own shares trade at a significant discount to their intrinsic worth.
 - We believe there are both cyclical and structural attractions from this style of investing. In the near term, it is evident – as is always the case after a major upturn in bank bad and doubtful debt charges – that bank credit criteria tighten significantly. In many cases, they do so to the exclusion of lending to highly asset backed, liquid or cash flow covered assets, simply because of new “mandates” laid down by a centrist management or credit group. Further, in this environment, banks typically look to “work-out” troubled loans by either selling the underlying collateral at sometimes unattractive prices or increasingly by assigning the loan at a discount to par value. In both cases, banks are spared the ongoing management cost and effort of monitoring a provisioned exposure.
 - In the long term, the Directors see the increased willingness of banks to transact their Australian loan exposures as a positive opportunity which was previously out of scope.

2.3. Finding the appropriate new Manager

- There are very few fund managers operating in the Australian market who have the skills sets and network of connections required to operate in the manner discussed above. Most Australian domiciled fund managers have tended to operate relatively simple “long” type portfolios within the larger listed Australian stocks, rather than investing over a broader range of asset classes.
- Further, the Independent Directors believe that it is desirable for the Manager to have various non-direct investment skills such as a strong legal capability, which ensures the analytical and drafting skills necessary to create attractive unlisted exposures to listed securities can be created “in-house”.
- The Independent Directors are desirous of ensuring the Manager puts their “money where their mouth is”. Merricks Capital, described in greater detail below, fits all of these criteria.
- Merricks Capital has a large analytical team, operating in some unconventional areas, in-house legal expertise, strong networks across high net worth investors, and is the Fund's largest shareholder. If the Fund doesn't perform, Merricks Capital bears the largest opportunity cost.

3. Comments by Adrian Redlich Merricks Capital's Chief Investment Officer

3.1. Introduction

- I would like to introduce you to Merricks Capital and our investment philosophy. The firm was established in 2007 and the majority of the senior members of our team are investment professionals who I have worked with at Merrill Lynch or Citadel Investment Group in Melbourne, New York, Hong Kong or Chicago over the last seventeen years.
- We all share a passion for investing and believe strongly in generating absolute returns.
- The investment community's fixation with tracking a benchmark is nonsense in our opinion and in large part driven by people who are not necessarily investing their own money. At Merricks Capital the owners of the business are also significant investors in all our funds.

"Put our money where our mouth is"

- Our unlisted funds have made money in each of the last three years irrespective of the dramatic swings in equity, commodity and credit markets. In large part this is due to only taking risk where we believe we will get a good return commensurate with the risk we are taking.
- I am not suggesting that we never lose money in any investment but rather we are driven by a core philosophy of investing our money alongside our investors only when the return profile is compelling and the opportunity is in our core area of expertise.

"Where preparation meets opportunity"

- Having had the fortune of running multi-billion dollar absolute return portfolios within the confines of one of the world's biggest funds we chose to start our own more nimble business. However, despite being an emerging fund manager we place enormous value on the investment process and preparation as it is the cornerstone of our investment ethos.
- Consistently finding great risk adjusted investment opportunities are generally not uncovered by *"two guys and a Bloomberg terminal"*. A core ethos of Merricks Capital is that good investment returns result *"where preparation meets opportunity"*. There are four pillars to our preparation:
 - **Team** - The Merricks Capital team consists of 12 people and the senior investment professionals have spent considerable time working in the US and Asia for global fund managers and investment banks.
 - **Infrastructure** - Merricks Capital has built a robust institutional grade platform to generate positive returns whilst mitigating operational risk.
 - **Relationships** - The Merricks Capital have long standing key relationships in Australia and around the world.
 - **Core area of expertise** - All of Merricks Capital's investment ideas are generated by detailed bottom up fundamental research by analysts who have specialised industry and sector knowledge and experience.
 - I encourage shareholders to visit the Merricks Capital website at merrickscapital.com to learn more about our team and other funds.

3.2. Why Merricks Capital invested in the Fat Prophets Australia Fund?

- Currently Merricks Capital owns 19.3% of the Fund and our approach to this acquisition was simple as we were able to buy shares at a discount to underlying value.
- We are aligned with all shareholders seeking good returns over the long term.
- We believe the root cause of listed investment companies currently trading at big discounts to NTA is due to market perception that permanent capital and the long term management agreements are negatives. Ironically we see this as a strength of the Fund and one which should be turned to all shareholders' advantage.
- The Fund's shareholders could, at no incremental cost, get the advantage of the significant investment that Merricks Capital has made in its infrastructure.

3.3. Permanent capital is huge advantage in the current investing environment

- The structure of the Fund allows the Fund to invest in opportunities and segments of the economy where there is a lack of capital being allocated.
- In our experience the best risk adjusted returns are often found in investment segments which are suffering from a scarcity of capital. Investing where there is a lack of risk capital is not a secret formula but rather an opportunity that simply cannot be pursued by most investors due to institutional restrictions, narrow mandates or the need to generate monthly returns.
- The Fund does not need be constrained because it is not managing for monthly performance and as a result has the confidence and liquidity to invest in opportunities that may require twelve to twenty four months of patience.

3.4. New mandate

- As Funds Manager we are well aware that trust is not easily won. We have spent considerable time discussing the future direction and investment mandate of the Fund with the Independent Directors and external advisors.
- A formal process always takes longer than anyone would desire and we apologise for the investment hiatus over the last month. However, both Merricks Capital and the Independent Directors are in unanimous agreement that our Fund boldly moves to pursue fewer high conviction opportunities.
- We are currently reviewing several opportunities that fit within the context of the new mandate and hope to be in a position to execute on one or two in the near future.
- Going forward we will announce any material investment at the time of investment and endeavour to provide detailed research and support for each opportunity.

Appendix A

Investment Mandate for Fat Prophets Australia Fund Limited

Under the Management Agreement, the Manager is permitted to undertake investments on behalf of the Company without Board approval. However, if the proposed investment is not in accordance with the investment principles outlined below, Board approval for the investment must be obtained.

Investments that may be made by the Manager are limited to the following:

- (a) listed securities, being any security quoted on the ASX or another licensed market, including without limitation, shares, stapled securities, units or notes which are redeemable, preference or deferred, fully or partly paid, with or without any right, title or interest (including a right to subscribe for or convert to any such security and including a right to subscribe for or convert to any such security if it is unlisted);
- (b) unlisted securities in Australian domiciled companies being any security including without limitation, shares, stapled securities, units or notes which are redeemable, preference or deferred, fully or partly paid,
- (c) warrants, options and ASX indices to purchase any investment and warrants, options and ASX indices to sell any investment which is a permitted investment;
- (d) cash, including cheques, bank deposits, bank transfers, bank drafts and bills of exchange
- (e) debentures, unsecured notes and bonds of in a company;
- (f) provision of loans including but not limited to convertible notes to Australian domicile companies;
- (g) units or other interests in cash management trusts;
- (h) units or other interest in Australian domiciled trusts;
- (i) futures or derivatives contracts over Australian shares, bonds or equity indices or any other kind of foreign currency hedging; and
- (j) any other financial products which the Manager may use in the management of the Portfolio in accordance with its Australian Financial Services Licence.