



INTRODUCTION

In this week's report, we launch our new model portfolio and spend a few pages describing why we have taken the approach we have, as well as a bit of info on some of the stocks that comprise it. Every week we will have a dedicated section at the end to show you how the portfolio is progressing as well as identifying any changes that were made during the week. For simplicity, we have made the inception date as Monday 21 October 2013, and have taken the prices on the open. With the market at 5 year highs and plenty of stocks fully valued, we have obviously launched it at a challenging time to beat the market. So we look forward to reviewing the performance. Our initial cash holding also gives us the ability to make additional purchases on any market pullback.

In our Charting section today, we have identified a few trading opportunities in ASX, AUT, and CDU. While they don't pass the test as a long term investment, they could potentially provide some great returns in the short term.

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COMPANIES AND SECTORS

FUNDAMENTAL ANALYSIS COMBINED WITH A CHARTIST'S VIEW

THE 'FE200' MODEL PORTFOLIO

We have been writing on stock ideas for a couple of months. We felt we needed to be held accountable for our ideas, so we have decided to create a model portfolio, with our top picks concentrated together into a portfolio, which is compared with the ASX 200 index. With reference to the index, we call this model portfolio the 'FE200', (Fairmont Equities 200). We believe, in recommending stocks, they at least outperform the index. Over the past two months, we have identified eighteen stocks we believe are likely to outperform. We have written about a few of them below. In the table below, we have identified the 'relative bet' we have on these stocks. That is, if our portfolio is compared to the index, we have more exposure to each of these stocks (with the exception of Telstra, where we are less exposed than the index). This means that we will benefit as these shares perform better than the ASX 200. Conversely, we will fare poorly if the index performs better than these stocks. Telstra, as an 'underweight', finds the reverse true. We benefit if Telstra performs worse than the benchmark. It doesn't mean we don't like it, but it tends to mean we are positive on the market in general.

Table 1 Fairmont Equities 'FE200' Model portfolio

Ticker	Name	Sector	Index weight	Portfolio weight	Relative bet
ANZ	Aust & NZ Bank Grp	Financials	6.71%	10.00%	3.29%
BHP	BHP Billiton Ltd	Materials	8.81%	10.00%	1.19%
BEN	Bendigo & Adelaide	Financials	0.33%	5.00%	4.67%
WOW	Woolworths Ltd	Consumer Staples	3.26%	6.00%	2.74%
RIO	Rio Tinto Limited	Materials	2.12%	5.00%	2.88%
TLS	Telstra Corp Ltd	Telecommunication Services	4.80%	3.50%	-1.30%
LEI	Leighton Holdings	Industrials	0.20%	3.00%	2.80%
MQG	Macquarie Grp Ltd	Financials	1.31%	4.50%	3.19%
TOL	Toll Hldgs Ltd	Industrials	0.30%	5.00%	4.70%
STO	Santos Limited	Energy	1.09%	5.00%	3.91%
CTX	Caltex Australia	Energy	0.19%	4.00%	3.81%
CPU	Computershare Ltd	Information Technology	0.40%	3.00%	2.60%
QBE	QBE Ins Group	Financials	1.37%	5.00%	3.63%
SHL	Sonic Healthcare	Health Care	0.48%	3.50%	3.02%
LLC	Lend Lease Group	Financials	0.42%	3.00%	2.58%
NCM	Newcrest Mining	Materials	0.63%	3.00%	2.37%
TEN	Ten Network Hldgs	Consumer Discretionary	0.03%	3.00%	2.97%
SIP	Sigma Pharma	Health Care	0.05%	3.00%	2.95%
AGO	Atlas Iron Limited	Materials	0.06%	3.00%	2.94%

Identifying our favoured stocks, we compare valuation metrics against the index. We find that our portfolio, on average, enjoys a higher expected growth rate to the index. While the ASX200 index is expected to grow earnings on average by 6.1%, the stocks in our portfolio collectively are expected to grow earnings by 10.4%, thanks to holdings in Macquarie Group (market expects 21% EPS growth next year), Newcrest (53%) and Rio Tinto (11%). Our portfolio also shows more value investing than the index, with the ASX200 PE ratio of 15.3 times compared with our portfolio average PE ratio of 14.1 times. This reflects our hunt for stocks with lower than market average PE ratios, something our regular readers will notice. The earnings growth and low PE also naturally culminate to produce a portfolio expected return on equity (15.9%) in excess of the expected ASX200 return on equity of 14.2%. This is not to say that the ASX200 is expected to return 14%, it is to say that on average, the companies that make up the ASX200



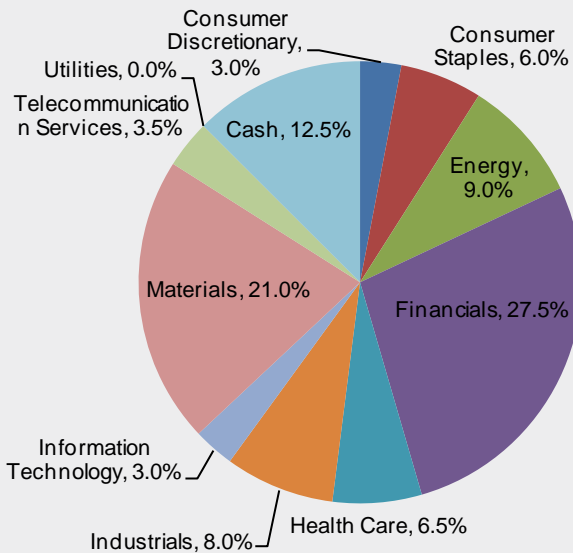
are expected to generate 14.2% return on shareholders' equity. This is also indicative that our portfolio seeks the higher returning stocks of the ASX200, leading to outperformance. However, with the apparent value in our portfolio, it does come at the expense of yield. While the ASX 200 forward dividend yield is 4.2%, our portfolio yield is only 3.3%, indicating the growth nature of the stocks we are owning. With most income stocks, which inflate the ASX 200 average yield, being mature companies with high payout ratios, we have chosen companies that have mostly adopted lower payout ratios, as they fund growth internally.

Figure 1 Portfolio characteristics (Source: Fairmont Equities, State Street)

	ASX200	Portfolio
Est. 3-5 Year EPS Growth	6.16%	10.40%
Dividend Yield	4.23%	3.35%
Fiscal Year 1 Price/Earnings	15.34	14.11
Return on Equity	14.25%	15.92%

Looking at the sector composition of the FE200 model portfolio, it is well diversified by sector. With the largest industries on the index being Financials and Materials, we have balanced our exposure to both industries, keeping them largely similar in weight, with Materials making 21% of our portfolio value and Financials 28%. We also have small, diversified exposure to every other sector covered in the ASX 200. As we find opportunities for stocks with good returns, or we identify industries with bright horizons, our sector exposures will change. However, it is a great way to identify risks and exposures from an industry level.

Figure 2 FE200 sector composition



Now that we have introduced the FE200, we would like to summarise six of the stocks in the model portfolio, reiterating why we see value in these names, with potential returns over and above index returns.



WOOLWORTHS LIMITED (WOW)

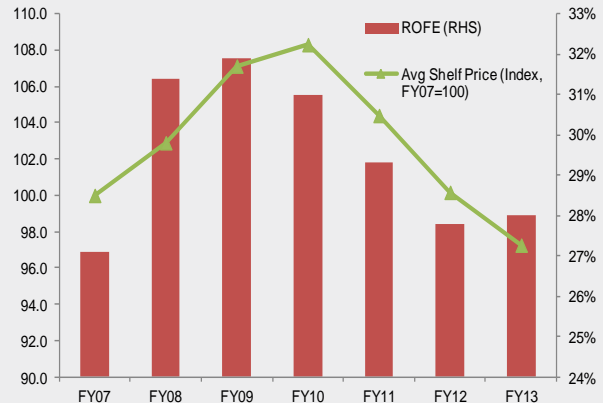
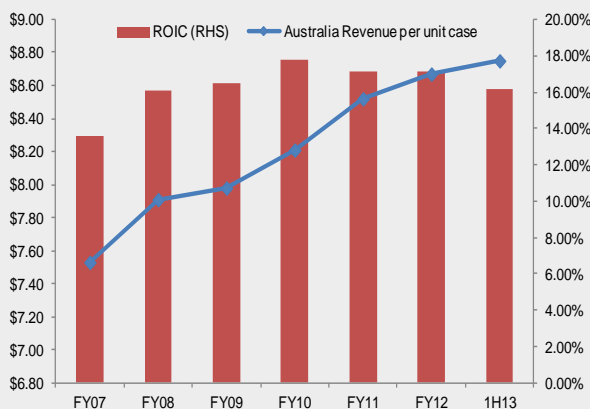
POSITIVE

Last share price	\$33.96	CURRENT BROKER RECOMMENDATIONS (Number of Brokers per recommendation)	
Market Cap (A\$m)	43.27B	Buy/Outperform	2
Return on equity	28.9%	Hold/Neutral	4
12 month forward PE	16.2x	Sell/Underperform	7
1 year EPS growth	6.1%	Average consensus target	\$32.83
Div Yield	4.3%	Target return	-3.3%

Woolworths is a part of our model portfolio. While its FY13 results were at expectations, demonstrating a mature business operating in a 'normal' environment, as equity investors we are more interested in management's outlook for the business over the future. Management guided 4-7% of earnings growth next year with no foreseeable macroeconomic obstacles. The company also outlined its investment guidance next year in the form of capital expenditure, noticing a marked shift from store roll outs to improvement in efficiencies. While an inward-looking investment program appears to signal of the end of strong external growth, there is a major difference in Woolworths' business model from Coca-Cola Amatil, another example of a company engaged in inward-looking capital investment, which makes us believe it will be successful over the coming years. Unlike Woolworths, which has been operating in an environment of falling prices, CCA has been raising prices and volume simultaneously, on top of the cost efficiencies from its investments. This quest for high returns on capital backfired, snapping returns as customers have switched away from CCA's product line.

Figure 3 Coca-Cola Amatil has been raising prices while returns are slipping (Source: Fairmont Equities, Company Reports)

Figure 4 Woolworths have been sustainably sharing returns with customers and shareholders (Source: Fairmont Equities, Company Reports)



Woolworths' business model has long been to distribute its returns not just among shareholders, but also to customers in the form of price discounting. As Woolworths competes and customers benefit from lower prices, market share rises in its existing stores fuel further returns, as long as they are matched by reinvestment into cost efficiencies. This is precisely what is happening now. After Woolworths has expanded its store network across Australia, in the face of increased competition from Coles, it is deploying capital to reduce its cost of doing business, in order to protect its leading market share and ensure future returns to shareholders and customers. For this reason, we see Woolworths' returns as sustainable into the future.



CHART VIEW – WOOLWORTHS

WOW is looking very capable of wanting to hit all time highs before the end of the year. After rallying strongly in August, it has pulled back in 3 waves under the April high. This 3 wave pullback under the high is telling us that it is using up a bit of time before getting ready for another strong move up to break that \$36.81 level set in April this year. Yesterday's gap up is the buy signal that long term investors have been waiting for.

Figure 5 Woolworths daily share price chart





TOLL HOLDINGS LIMITED (TOL)

POSITIVE

		CURRENT BROKER RECOMMENDATIONS (Number of Brokers per recommendation)	
Last share price	\$5.73		
Market Cap (A\$m)	4.10B	Buy/Outperform	3
Return on equity	11.5%	Hold/Neutral	5
12 month forward PE	13.3x	Sell/Underperform	4
1 year EPS growth	4.9%	Average consensus target	\$5.45
Div Yield	5.2%	Target return	-4.9%

From previous election report, we wrote that an increase in Government savings will unleash household savings, that the natural outperformer going forward would be discretionary retail. Given the underperformance discretionary retail suffered in the aftermath of the GFC, as the Government was increasing the budget deficit and households were saving, a reverse situation could emerge, accentuated by further declines in the dollar. This would make domestic retailers look more appealing to consumers, especially since retailers have the benefit of inventory purchased in bulk at a higher exchange rate. While internet retailing will remain a permanent and structural threat to 'bricks and mortar' retailers, as evidenced by consistently weak department store sales, high-quality retailers with their 'finger on the pulse' of consumer demand will fare quite well in a resurgent consumer environment. However, we cannot recommend a high quality undervalued retailer at this point in time. They're either flawed business models or expensive, with most growth priced in.

However, if we look towards a supplier industry of the retail sector, we identify good opportunities in the logistics/supply chain space. One of the stand-out names in this sector is Toll Holdings (TOL). As discretionary retail sales increase, volumes would increase throughout Toll's existing logistics network. The high fixed costs underlying a logistics network means levered earnings growth rates for given revenue growth. This fixed-cost leverage, while working against Toll over the past few years as discretionary retail was weak, will immensely assist EPS growth in an environment of growing discretionary retail sales. Looking at current returns on capital the company is generating, as well as cash flow issues surrounding dividend coverage, the current 13.2x earnings multiple on next years' earnings would be easy to justify. However, this multiple could easily re-rate and trade at a premium to market, as it has done so historically. Owning TOL in such a scenario would reward investors with strong returns over and above the market.

CHART VIEW – TOLL HOLDINGS

We last covered TOL on 20 August when it was trading at \$5.29. We wrote "From its lows 12 months ago, we have seen TOL do all the right things on the charts. It has rallied impulsively while the pullbacks have been shallower in nature. These pullbacks tend to use up a lot of time without the prices heading too far south". Since then it has not only traded higher, but paid a 15c dividend. We continue to see the trend in TOL as positive and current levels are still a buying opportunity where it should head towards \$6.50 - \$7 over the next several months.



Figure 6 Toll Holdings daily share price chart



SANTOS LIMITED (STO)

POSITIVE

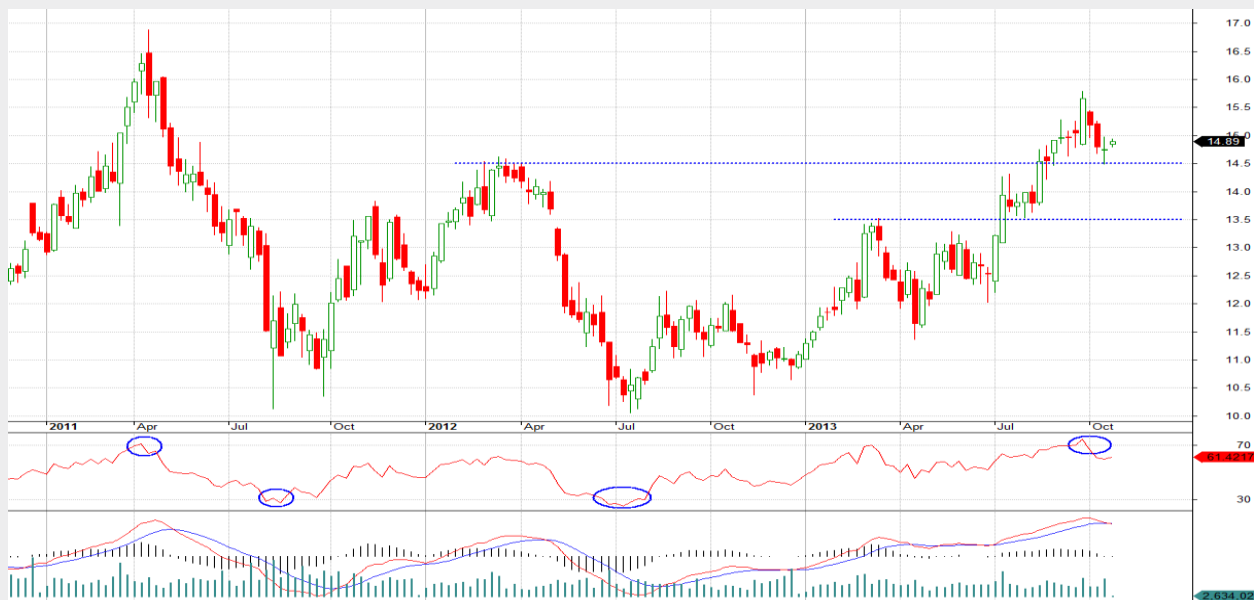
		CURRENT BROKER RECOMMENDATIONS (Number of Brokers per recommendation)	
Last share price	\$14.75	Buy/Outperform	7
Market Cap (A\$m)	14.39B	Hold/Neutral	5
Return on equity	7.5%	Sell/Underperform	1
12 month forward PE	20.2x	Average consensus target	\$15.76
1 year EPS growth	14.1%	Target return	6.8%
Div Yield	2.2%		

Santos operates in the Cooper Basin, which, while in decline, sees a much brighter 10 years for Santos with production to increase by 60% to more than 75 mmbob. This is thanks to new east-coast CSG to LNG and Papua New Guinea LNG projects. Santos boasts some of the largest and highest-quality CSG reserves in Australia. East-coast LNG should attract export pricing and indirectly drive domestic sales to export parity. While the investment thesis surrounding Santos was based on gas-hungry Asian markets attracting prices triple Australian levels, this has abated, however the potential to direct gas to the east-coast will pressure prices locally. Santos' enviable domestic infrastructure footprint drives enhanced returns at minimum cost. We are positive on Santos for its optionality – its existing infrastructure servicing east coast markets and Queensland ports allow it to efficiently supply gas to domestic or overseas markets, where it is most viable to do so. In a reversion of focus to the domestic market, we are positive on Santos.

CHART VIEW – SANTOS

We last looked at STO on 8 October when it was trading at \$15.19 and our advice at the time was to wait and get it at cheaper levels. We can see that while the market has rallied 200 points since then, STO has indeed drifted back. It may get to levels as low as \$13.50 but drifting back to the low \$14's would still be a buying opportunity in our opinion.

Figure 7 Santos weekly share price chart



QBE INSURANCE GROUP LIMITED (QBE)

POSITIVE

Last share price	\$14.59	CURRENT BROKER RECOMMENDATIONS (Number of Brokers per recommendation)	
Market Cap (A\$m)	17.90B	Buy/Outperform	4
Return on equity	12.4%	Hold/Neutral	8
12 month forward PE	12.8x	Sell/Underperform	3
1 year EPS growth	17.5%	Average consensus target	\$15.25
Div Yield	3.0 %	Target return	4.5%

With the recent discussion about the US Federal Reserve 'tapering', or reducing, its quantitative easing programme, bond yields in the United States have markedly risen as investors sell out of Government bonds and begin investing in assets such as domestic equities. The resulting flight from emerging markets has affected Australian markets too, with the fall in the Australian dollar and increasing Australian 10 year bond yield over the past 12 months. An effective way to play movements in bond markets is with insurers – a substantial proportion of an insurers profit comes from returns on mostly fixed income investments. We view QBE as a particular name that would be impacted by rising interest rates. With 64% of its investments held in Australian and US dollars, its investments are mostly exposed to the yield curve both in Australia and the United States.

Figure 8 QBE Investment exposure by currency (Source: Fairmont Equities, Company Reports)

Figure 9 QBE Investment allocation, heavily exposed to interest rates (Source: Fairmont Equities, Company Reports)

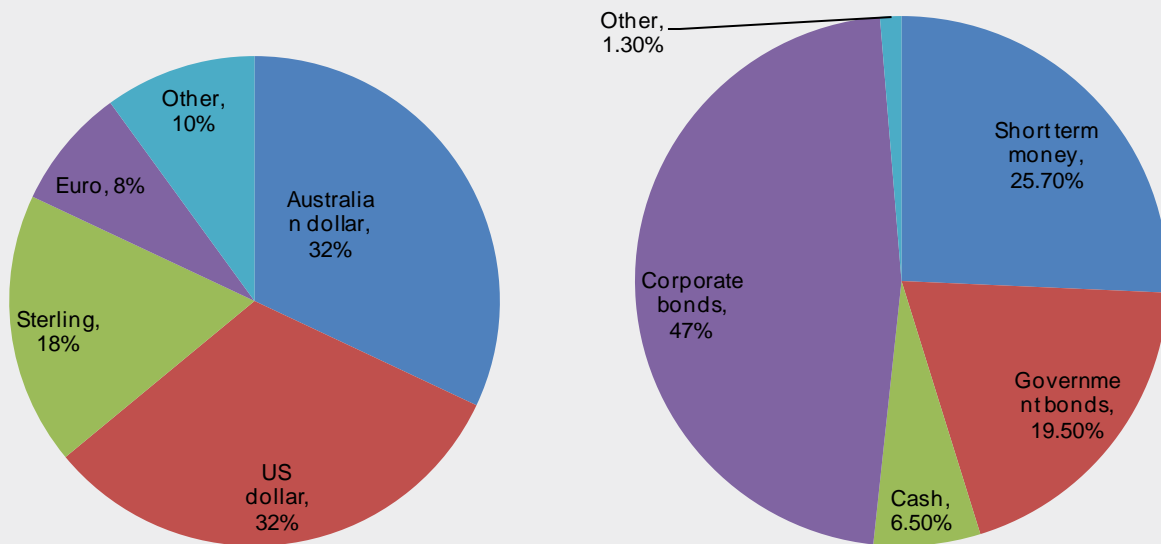


CHART VIEW – QBE

Our view on QBE remains unchanged from the last few months. The breakout on the downside from the rising wedge sent it back towards \$14.50 which is the level where investors can confidentially step back in. Upside targets for next year remain towards \$19, with initial resistance to be found at \$16.50.



Figure 10 QBE daily share price chart





CALTEX AUSTRALIA LIMITED (CTX)

POSITIVE

		CURRENT BROKER RECOMMENDATIONS (Number of Brokers per recommendation)	
Last share price	\$18.60		
Market Cap (A\$m)	5.04B	Buy/Outperform	2
Return on equity	20.4%	Hold/Neutral	4
12 month forward PE	11.5x	Sell/Underperform	3
1 year EPS growth	11.7%	Average consensus target	\$19.09
Div Yield	3.1%	Target return	2.6%

Caltex owns and operates refineries at Kurnell in Sydney and Lytton in Brisbane. Combined capacity is more than 35 million litres per day, around two-thirds of company marketed volumes. The refineries run at only 80% capacity due to operational issues and unfavourable demand at Kurnell. Kurnell was built to produce petrol, but the market has moved increasingly to diesel with advancing engine technology. Refineries and finished product import terminals are integrated with pipelines, distribution and marketing. The national service station network exceeds 2,000 including 350 jointly branded Caltex/Woolworths sites. With volatile earnings in the past, Caltex is intending on improving what it calls "product sourcing", in other words, reduce input costs. It believes it could achieve this by importation of fuel, rather than onshore refining. It also aims to "enhance competitive infrastructure", improving efficiency.

With management reducing the source of so much earnings volatility, what's left is a fuel distribution business with considerable market share in Australia growing at GDP. We believe such a business, with stable predictable earnings with large market share and barriers to entry, should deserve a market multiple. For this reason, we can envisage Caltex trading up to 15x earnings, which would imply about 25% share price appreciation at current earnings levels. We note that the process of realigning itself, the conversion of Kurnell and the development of distribution infrastructure, is costly. In fact, its recent 1H13 financial statements do mention \$112 million of committed capital expenditure over the next twelve months. We also note this capital expenditure is at the same rate as has been over the past twelve months, and can be fully funded by its retained earnings, with a payout ratio of between 60-65%. With historical returns on equity well above 9% (the inverse of its current market PE), we believe Caltex is fundamentally undervalued!

CHART VIEW – CALTEX

Caltex is stuck in a channel between about \$18 and \$19.50. If CTX breaks the \$19.50 region, then we should expect CTX to trade in a new channel of equal depth. This means that the next level of resistance is up towards \$21, which coincidentally happens to be obvious resistance anyway. If that level gets broken, expect levels as high as \$24 for CTX.



Figure 11 Caltex daily share price chart





MACQUARIE GROUP LIMITED (MQG)

POSITIVE

		CURRENT BROKER RECOMMENDATIONS (Number of Brokers per recommendation)	
Last share price	\$50.17		
Market Cap (A\$m)	17.34B	Buy/Outperform	2
Return on equity	11.1%	Hold/Neutral	5
12 month forward PE	13.9	Sell/Underperform	0
1 year EPS growth	20.5%	Average consensus target	\$47.64
Div Yield	4.6%	Target return	-5.0%

Since the Global Financial Crisis, Governments around the world have been prompted to act on making sure such a systemic shock does not occur again. Australia is no exception. A global regulatory standard, known as [Basel III](#), aims to respond to the deficiencies in financial regulation that have emerged since the GFC. The issue with Basel III is the additional capital required to be reserved by banks. This additional capital reserve is a drag on bank return on equity. While regulation has impeded bank returns on equity, these regulations apply to all banks, with bottom-line impacts more dependent on bank operational performance. Macquarie's high exposure to markets means that earnings will grow strongest during bullish markets.

Why will Macquarie outperform during good times? With the restructure of the group into an 'annuities' style business and a rather market exposed business, stronger equity markets will positively impact most business lines.

Macquarie Securities and FICC would be the direct beneficiaries of good market conditions, with rising broking volumes and trading gains. While Macquarie Securities Group posted a \$50 million loss last year, with a fixed cost base this can quickly change and emerge as a growth driver for Macquarie Group's earnings. Strong market conditions and a low interest rate environment also mean companies enjoy a lower cost of capital, leading to increased corporate activity. Macquarie Capital would directly benefit from this – and again with a high fixed cost base, enjoys operating leverage.

While the market exposed businesses should perform well in a bullish market, this does not mean its 'annuity' businesses – BFS, MFG and CAF – will be mediocre. While the earnings profile from these businesses are more stable, rising markets directly impact MFG's earnings outlook, with rising funds under management meaning an increase in management fees, with the potential bonus of performance fees. Low interest rate environments with strong business confidence also increase demand for asset leasing solutions, leading to an increase in revenues for CAF.

Overall, while one can easily form a view of Macquarie being a symbol of the excesses of days gone by, the business has restructured itself for sustainability – proving itself as holding its head above water, waiting for the next metaphorical tide to rise. Trading just below the market multiple at 14 times, Macquarie is capable of achieving earnings well in excess of the market when things are good – which would lead to impressive performance, both from increased earnings and a re-rated multiple over and above the market average. It's happened before, it can happen again.

CHART VIEW – MACQUARIE GROUP

We've covered MQG a couple of times in the last two months, firstly identifying the breakout from the \$44 level. After rallying to \$50, the stock then drifted back to retest the upper breakout levels at \$47 before commencing another run. Another drift back to under \$50 is a final buying opportunity as the stock is heading to at least \$57 at some point in the next few months.



Figure 12 Macquarie Group daily share price chart





CHARTING

A TECHNICAL ANALYST'S VIEW

ASX LIMITED (ASX)

POSITIVE

		CURRENT BROKER RECOMMENDATIONS (Number of Brokers per recommendation)	
Last share price	\$35.03	Buy/Outperform	2
Market Cap (A\$m)	6.89B	Hold/Neutral	8
Return on equity	11.0%	Sell/Underperform	6
12 month forward PE	16.4x	Average consensus target	\$34.14
1 year EPS growth	8.1%	Target return	-2.5%
Div Yield	5.5%		

A good trading opportunity is developing with ASX. Like PPT and TAH which we have identified before and have done really well, ASX is also exhibiting the same bullish characteristics. It rallied strongly off the June low on good volume, and has since drifted back in 3 waves on lower volume. Yesterday's price movement indicates that ASX is now breaking out of this congestive pattern. If that is the case, we should expect it to rally up towards \$38.

Figure 13 ASX daily share price chart



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AURORA OIL & GAS LIMITED (AUT)

POSITIVE

Last share price	\$3.31	CURRENT BROKER RECOMMENDATIONS (Number of Brokers per recommendation)	
Market Cap (A\$m)	1.52B	Buy/Outperform	7
Return on equity	28.2%	Hold/Neutral	3
12 month forward PE	7.4x	Sell/Underperform	1
1 year EPS growth	50.0%	Average consensus target	\$3.82
Div Yield	n/a	Target return	15.4%

AUT has been congesting in a very clear symmetrical triangle pattern since July this year. Volume has also been low throughout which is a good sign. A few weeks ago we saw it make a little false break to the downside which sucked out the last of the sellers. We have seen these false breaks happen before with other stocks and the most likely result is a breakout here from the symmetrical triangle and a quick rally up towards resistance at \$3.90. Once it breaks out to the upside, traders should place their stops just under the breakout point.

Figure 14 Aurora daily share price chart



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CUDECO LIMITED (CDU)

POSITIVE

Last share price	\$2.16	CURRENT BROKER RECOMMENDATIONS (Number of Brokers per recommendation)	
Market Cap (A\$m)	470.81M	Buy/Outperform	0
Return on equity	12.2%	Hold/Neutral	0
12 month forward PE	n/a	Sell/Underperform	0
1 year EPS growth	n/a	Average consensus target	n/a
Div Yield	n/a	Target return	n/a

We first covered CDU on 20 August when it was trading at \$1.62. We noted at the time "Not only are we seeing divergence with the RSI here (indicating a potential bounce), but volume has come in very strongly at the bottom of this downtrend. Often that is a sign of accumulation as the bigger players start to position themselves and the retail investors try to exit the stock out of frustration." Since then we can see that the stock has clearly bounced strongly and has traded very well. The moves up are impulsive and the pullbacks are very corrective. Price action in the last two days suggest that CDU is on the move again so traders can follow it with a target expected to be just over \$3.

Figure 15 CuDeco daily share price chart





UPCOMING EVENTS

MEDIA

TELEVISION

SKY NEWS BUSINESS CHANNEL

"Your Money, Your Call" on Wednesday 6th November 2013 at 8pm and Tuesday 12th November at 8pm

CONFERENCES

Our analyst Ninus Kanna will be a panellist at 'A very different Australian Property Conference' Wednesday 23rd October at 8.30am. The conference will be held at Level 47, MLC Tower in Sydney. If readers are interested, please contact us.



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