

Selector Aust Equities Ex 50 Fund
Quarterly Newsletter No.34



June 2013

In this quarterly edition we review performance and attribution. We introduce Virtus Health an IPO. We do a roundup of investor day briefing season. Our macro focus is on the US and at home we take a look at the Federal Budget. Photo: STOP (fast) Press.

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About Selector

We are a boutique fund manager and we have a combined experience of over 150 years. We believe in long term wealth creation and building lasting relationships with our investors.

Our focus is stock selection. Our funds are high conviction, concentrated and index unaware. As a result we have low turnover and produce tax effective returns.

First we identify the best business franchises with the best management teams. Then we focus on valuations.

When we arrive at work each day we are reminded that;

“The art of successful investment is the patient investor taking money from the impatient investor”.

Our fund is open to new subscriptions. Please forward to us contact details if you would like future newsletters to be emailed to family, friends or business

Dear Investor,

As we rule off for another financial year, investors are again jumpy. This time the culprit is the US Federal Reserve chairman Ben Bernanke. Ever since the global crisis of 2008, governments have been scrambling to keep their respective economies afloat. The US in particular has been ever vigilant with a bond buying program known as “quantitative easing” with the intention of supporting the US economy, resulting in the Federal Funds rate remaining close to zero. But Bernanke’s comments in June that the central bank could start winding back its US\$85 billion a month bond buying program later this year and potentially ending by mid next year, sent investors fleeing.

The upshot has been a reassessment on the state of the US economy. Bernanke has previously commented that getting the unemployment rate down was a top priority, with the central bank now tipping the jobless rate to fall from the current 7.6% to between 6.5% and 6.8%. The fallout following Bernanke’s comments has seen the US dollar strengthen at the expense of most other currencies including the Australian dollar which has fallen sharply below parity.

Over the course of the year, global share markets have staged a strong recovery, catching most investors off guard. Some of the major market moves include the German DAX up 24.1%, the US Dow Jones Industrial Average up 15.7%, the UK FTSE index up 11.6% and the local All Ordinaries Accumulation Index up 20.7%.

While our local index has risen strongly, the gains haven’t been shared equally, with a large number of businesses feeling the pinch of a struggling resources market and tougher domestic conditions. Governments haven’t helped the cause, implementing a range of new taxes in order to plug a growing deficit. With elections planned for September and the dollar on the wane, we remain positive on the long term health of the economy despite some near term obstacles.

In this quarterly newsletter we revisit aspects of the financial year and comment on performance. We take a closer look at the newly floated IVF business Virtus Health, provide a round-up commentary on a number of investor day presentations we attended and end with a look at the US economy and our own via the recently released budget papers.

During the past quarter and for the financial year the Fund delivered a negative gross return of **0.40%** and a positive gross return of **36.63%** respectively, as compared to the All Ordinaries Accumulation Index which returned a negative **3.33%** for the past quarter and a positive **20.67%** over the past financial year. These results are pleasing and provide us with confidence that our investment approach is delivering meaningful results.

To all our investors we trust that you find the report informative.

Regards
Tony Scenna
Corey Vincent

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Fretting about time

Almost everything we do in life is measured against time - our age, when we eat, sporting events, school life, when we work, when we sleep. In the world of investments, the notion of time constantly surprises us. When our business expectations happen quicker than we envisage we are pleased. Equally, events that take longer to realise, result in disappointment. But as investors we have little control on either time or on the course of events.

We fret so much and measure so many points that sometimes we underestimate the importance of time. Think about all the risks in investing - management risk, industry risk, economic risk, interest rate risk and finally time risk. In this context, time would be the lowest form of risk.

So rather than measuring time points, spend that time to better understand what you have so has to allow time to work to your advantage rather than against you. **SFM**

Performance June 2013

For the quarter ending June 2013, the Fund delivered a gross negative return of **0.40%** as compared with the **3.33%** fall in the All Ordinaries Accumulation Index. Performance statistics are detailed on page 23.

Performance table since inception

% Returns	Gross Fund Return %	All Ords Index %	All Ords Acc Index %
3 months	-0.40	-4.11	-3.33
1 Year	+36.63	+15.47	+20.67
3 years	+11.73	+3.36	+7.96
5 years	+10.09	-2.18	+2.19
Since inception compound p.a.	+9.22	2.27	+6.61

Top 10 June 2013*	Top 10 March 2013*
Aristocrat Leisure	ARB Corporation
Flexigroup	Blackmores
Flight Centre	Flexigroup
IOOF Holdings	Flight Centre
IRESS	IOOF Holdings
ResMed Inc.	IRESS
SEEK	ResMed Inc.
Sirtex Medical	SEEK
Super Retail Group	Sirtex Medical
Technology One	Super Retail Group
Top 10 = 56.45%	Top 10 = 54.85%

*Listed in alphabetical order

Selector runs a high conviction index unaware stock selection investment strategy with typically 15-25 stocks chosen for the Fund. As shown above, the Fund's top 10 positions usually represent the great majority of its equity exposure. Current and past portfolio composition has historically been very unlike that of your average run-of-the-mill "index hugger" fund manager. Our stock selection to this point has not included either retail banks or the large resource companies, RIO and BHP. Our goal remains to focus on truly differentiated broad cap stock selection rather than the closet index hugging portfolios offered by most large fund managers.

Performance attribution for the quarter

Top 5 stock contributors	%	Top 5 stock detractors	%
ResMed	+1.02	Jumbo Interactive	-1.56
Aristocrat Leisure	+1.02	ARB Corporation	-0.62
Flexigroup	+0.98	IOOF	-0.58
Flight Centre	+0.86	Fleetwood Corporation	-0.55
Sirtex Medical	+0.76	SEEK	-0.49

A strong performance from the markets during the year hasn't necessarily translated across the universe of listed stocks. The following table breaks down some of the main indexes and as a snapshot it is pretty clear some investors aren't too pleased with how things have panned.

Australian stock exchange index performance 2012 - 2013

	30 June 2012	30 June 2013	% Change
S&P ASX 50	32,409.93	40,715.26	+25.6
S&P ASX 100	7,963.65	9,927.80	+24.7
S&P ASX 300	31,730.00	38,737.44	+22.1
S&P All Ordinaries	31,714.27	38,270.32	+20.7
S&P ASX Small Ordinaries	4,975.35	4,721.68	-5.1
S&P ASX 200 Materials	61,963.11	57,398.64	-7.4
S&P ASX 200 Energy	80,257.74	86,588.63	+7.9

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Overall the main index, the All Ordinaries Accumulation Index rose 20.7% for the year, although the returns can be split into two very distinct halves. For the period to December 2012, the index rose 15.5% while the second half has seen a more muted response, rising 4.4%. That said performance has varied across the listed landscape with both the materials (read resources sector) and the small ordinaries index, both struggling to record gains.

Similarly, the market's gain for the year has masked a number of declines among a host of top line businesses following profit downgrades. The list includes AGL Energy, Ausenco, Boral, Coca-Cola Amatil, Newcrest Mining, UGL Engineering, WorleyParsons, Lend Lease, Transfield Services, AMP, Cochlear and Transpacific Industries Group to name a few.

Ultimately though the price performance of a share is directly linked to a company's underlying business. Over time, those businesses that perform better, by investing sensibly, earning more profits and generating better returns on capital employed will be valued more highly by investors. It all sounds sensible, however, the difficult part is identifying the right businesses enjoying such key metrics and staying the course during difficult periods.

Identifying and selectively targeting management teams and businesses that make the grade consume the majority of our time and are reflected in the Fund's investment holdings. The Fund's performance is a direct reflection of how these businesses have performed over the short and long term, so in this regard the results generated by the Fund over the past year are both pleasing and reinforcing of our investment philosophy. **SFM**

Virtus Health (VRT)

Parting with your money on a new investment should come with a warning, particularly if the vendors happen to be the financially savvy types from private equity. A sleight of hand here, a deft touch there and before you know it, a promising purchase can quickly turn sour. Recent flops include national retailer Myer, flogged to the market during 2010 at the issue price of \$4.10 and more recently KFC franchisee operator Collins Foods, following its 2011 \$200 million raising at the offer price of \$2.50 per share. In both cases, private equity made a clean exit, while new shareholders were left nursing heavy losses as each share traded significantly below the offer prices. Fast forward and the situation today is little improved, with the Myer shares now changing hands at \$2.38 and Collins Foods on a better footing, although remaining well under water at \$1.68.

The birth of Virtus Health

And yet there may still be hope. During the quarter the Fund invested in one of the largest new public offerings in recent years. Virtus Health listed on the exchange in June, having raised \$339 million in new capital, providing the group with a market capitalisation of \$452 million, based on an issue price of \$5.68 per share.

So strong was the demand for stock, that founding investor Quadrant Private Equity completely exited their 45% shareholding, thereby pocketing a significant portion of the funds gathered. At its conclusion, new shareholders represent the bulk of the registry, while existing shareholders, including management, contracted specialists and company scientists continue to hold around 25%.

Virtus Health the business

Virtus Health is the country's largest provider of Assisted Reproductive Services (ARS), a general term that refers to methods used to achieve pregnancy by artificial or partially artificial means. One of the most common and perhaps well known ARS processes is that of In-Vitro Fertilisation or IVF. The involvement of Quadrant Private Equity led to the establishment of Virtus Health in 2008 following the integration of three founding ARS practices.

The origin of these practices and the specialists involved dated back to the early 1980's, with the early evolution of ARS. These clinics formed the nucleus of the business today and included the consolidation of four IVF clinics based in Sydney under the banner IVF Australia, Melbourne IVF and Queensland Fertility Group.

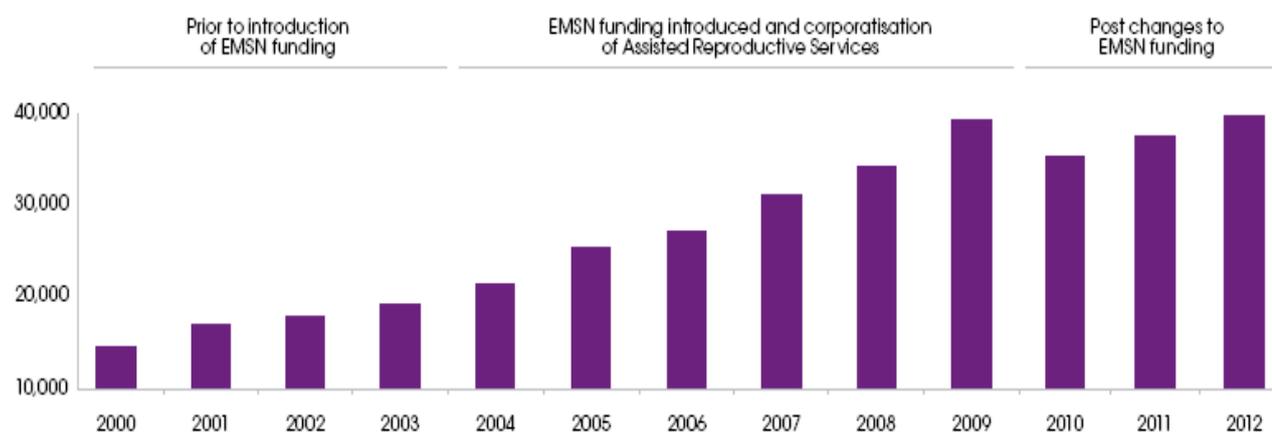
Background on ARS

The use of ARS has flourished over the past four decades because not all adults can conceive naturally. With better technology and improvements to overall success rates, couples have been offered a viable alternative. The first human IVF pregnancy was achieved in Australia in 1973, but, unfortunately, it resulted in an early miscarriage. On 25 July, 1978 the first IVF baby was born in England, while Australia's Candice Reed became our first and the world's third IVF baby in 1980. Since those early days, the number of IVF cycles completed in Australia each year has risen steadily as illustrated by **Chart 1**.

Since 2000, completed IVF cycles have grown at about 10% a year, hitting 40,000 during 2012. However, as we will discuss further, IVF comes with a hefty price tag and the onset of the financial crisis and introduction of a Medicare funding cap in 2009 certainly impacted the number of couples seeking treatment, such that cycle numbers are only now approaching the previous peak reached in 2009. Of the 24,000 women that undertook an IVF treatments, involving 40,000 cycles, 12,000 babies were born.

Chart 1: IVF Cycles in Australia

Number of IVF Cycles per calendar year

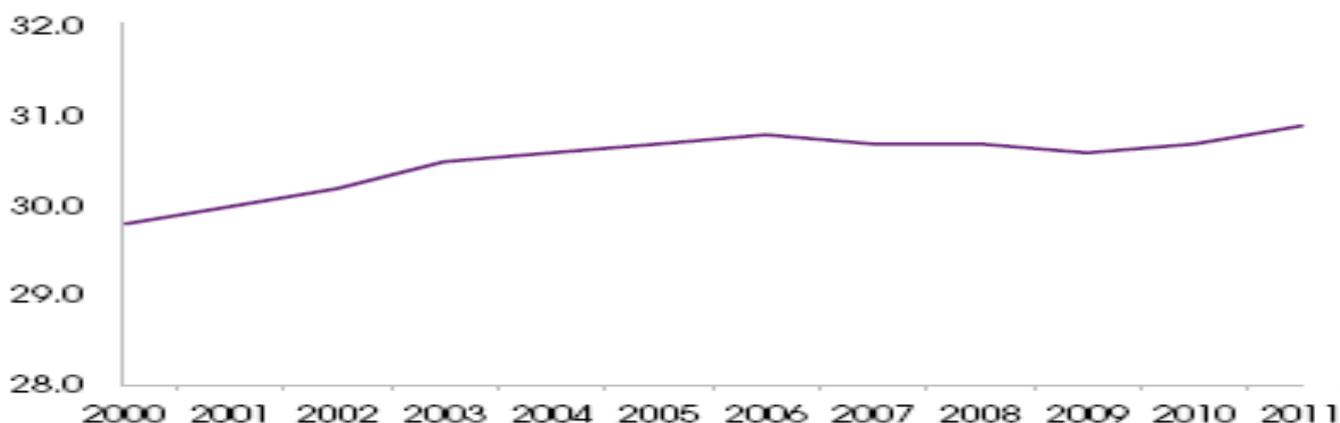


Source: Based on Medicare Benefit Schedule Item Statistic Reports for items 13200, 13201 and 13202 for the 12 months ending 31 December in each year <<https://www.medicareaustralia.gov.au/statistics/mbsitem.shtml>>.

A widely accepted definition of infertility is the inability to achieve pregnancy after twelve months of regular unprotected intercourse. Causes of infertility are varied however an equal weight (35%-40%) can be attributed to both males and females while unexplained issues (20%-30%) make up the balance. Supportive data suggests that around 12% of women aged 18-54 and 17% of all couples will experience infertility at either the first or subsequent child. However one of the biggest battles that couples face surrounds the decision of when to have children, with **Chart 2** highlighting this trend. Technology is now offering patients better targeted medical options and allowing even late age couples a chance to conceive but there are no guarantees.

Chart 2: Increasing median age of mothers

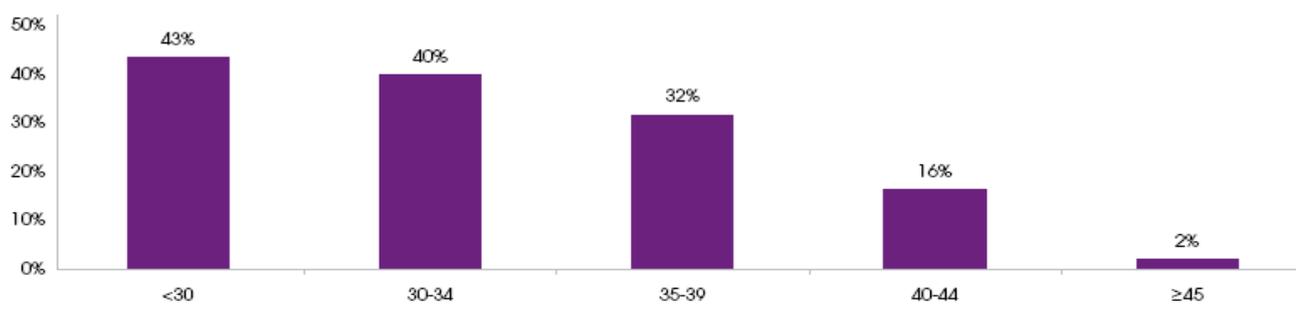
Female age (years)



Source: Australian Bureau of Statistics – *Births, Australia, 2011*.

Chart 3: Success rate for embryo transfer by age group

% of clinical pregnancies per embryo transfer cycle by age group (2010)
 Success rates for embryo transfer cycles by age group (Australia/New Zealand)



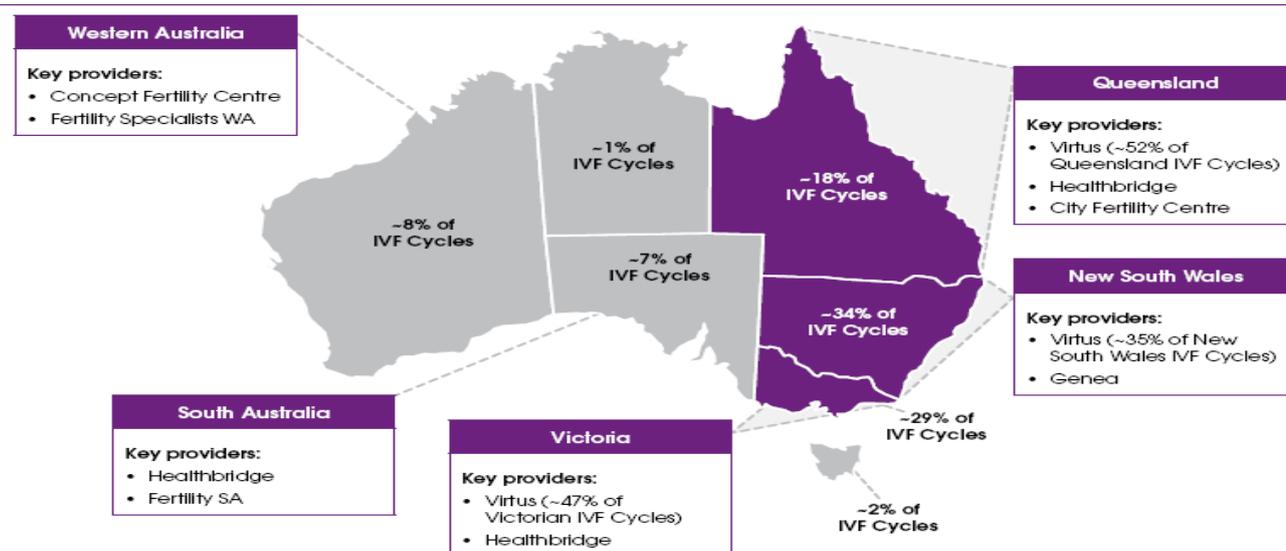
Source: Figures calculated from data published by the Australian Institute of Health and Welfare, *Assisted Reproductive Technology in Australia and New Zealand Report, 2010*.

Fertility drops with advancing age and the rate of conception success beyond forty years becomes a challenge as **Chart 3** highlights. For females under 39 years of age, the chance of success using embryo transfer can vary between 32%-43%, however beyond the age of 40 years the rate of success drops dramatically to 16% and only 2% for women over 45 years. Yet despite these odds, couples are grabbing the chance that IVF provides.

Virtus Health business model

The company operates a vertically integrated business model. That is, it provides a one stop shop to assist patients experiencing infertility issues. Via a network of 33 clinics located throughout the eastern seaboard of Australia, Virtus Health offers independent fertility specialists access to the group's complete service offering that encompasses over 824 staff including 164 scientific staff, 35 embryology and diagnostic laboratories and 6 day hospitals.

Graph 4: Australian IVF cycles and Virtus Health market share



As **Graph 4** illustrates, Virtus Health has thus far concentrated business activities within the three states of NSW, Victoria and Queensland. During 2012, these regions completed 81% of total IVF cycles undertaken in Australia, with the company enjoying leading market share positions of 35%, 47% and 52% respectively in each of the three states.

The role of the fertility specialist

However, for the model to work effectively and financially, Virtus Health remains reliant on the services of the contracted fertility specialists. Currently numbering 82, these independent fertility specialists enter into exclusive arrangements to utilise the services of Virtus Health when undertaking IVF treatments for patients. As such, a binding commercial relationship exists whereby one party is highly reliant on the other. In terms of remuneration, each fertility specialist is initially engaged for a five year period, upon which a set fee is paid for the management of each IVF cycle undertaken. In short, for each completed IVF cycle, the patient pays Virtus Health the full cost of the service from which a set fee is paid to the specialist.

As with any profession, gaining the necessary experience and establishing a reputable IVF practice takes many years. Virtus Health aims to assist its fertility specialists by providing both marketing and training services. Typically, an experienced IVF specialist averages over 200 IVF cycles per annum, whereas someone new to the profession will take upwards of two years to reach that target. Since 2010, Virtus Health has focused on growing the number of specialists on its books from 64 to 82. This is an important undertaking as specialists who retire or leave need to be replaced by newer, up and coming doctors.

Who pays what?

The Virtus Health prospectus sets out the various sources of funding available to the patient who undertakes an IVF procedure. As a medical services provider, Virtus Health is unique in having a high percentage of its revenue paid directly by the patient. The group is also free to set its own prices but is cognisant of the amount ultimately borne by the patient, referred to as the out of pocket expenses.

It is estimated that a standard IVF cycle will cost the patient something approaching \$10,000 and that fee is paid to the clinic at the time of egg collection. From this fee, Virtus Health runs its business covering expenses including staff, laboratories and day hospitals while also paying the IVF specialist a management fee of \$1,400 on average per IVF cycle. The patient on the other hand seeks reimbursement from a number of parties including the Government, under the various codes of Medicare and through individual private health cover. Under this example, a patient may end up with an out of pocket bill totaling \$3,500. Should a patient require the added services of advanced diagnostics, the total cost for an IVF cycle can hit \$14,000. Under such a scenario the patient picks up the bulk of the additional expense, with a final out of pocket bill of \$7,500.

As **Table 1** and **2** outline, the group's track record since 2010 has been supported by underlying demand. Operating a high fixed cost business structure, profits are highly reliant on the number of IVF cycles completed. The group's two largest cost lines include staff costs and provider fees. While staff costs are relatively fixed and are incurred irrespective of IVF volumes undertaken, provider fees reflect the payments to external IVF specialists. As such, a rising provider fee cost line should be viewed in a positive light as it reflects increasing volumes of completed IVF cycles.

During 2010, Virtus Health undertook 13,109 IVF cycles, serviced by an average of 62 fertility specialists. During 2014, management expects this to hit 15,409 delivered by some 82 specialists. The business generates high gross margins and requires low levels of ongoing capital expenditure, projected at approximately \$10 million per annum. By 2014, management forecasts group revenues of \$206 million, generating earnings before interest and tax (EBIT) of \$54 million and margins of 26%.

If achieved, the group's net profit forecasts of \$32 million, represents an earnings per share of 39 cents and a dividend payment of 26 cents, placing the shares on a prospective 2014 PER of 14 and a fully franked yield of 4.6%. Management has indicated the company's payout ratio will remain within the 50%-70% range, which is commercially sensible considering the significant level of debt the group now carries on its balance sheet.

However, maintaining historical IVF cycle growth rates may become a challenge. Patients undertaking IVF treatment are not guaranteed success and as such couples may need to undertake a number of cycles, each time incurring a significant out of pocket expense. Coupled with this, the company's stated intention of lifting procedure costs annually by 3%-5% and with further cuts to Medicare funding expected, patients have been left to shoulder a greater portion of the cost.

Table 1: Summary of Virtus Health Earnings 2010 - 2014

June year end, \$ million	Note	Pro Forma Historical Results			Pro Forma Forecast Results		Forecast Statutory Results	
		FY2010	FY2011	FY2012	FY2013	FY2014	FY2013	FY2014
Total revenue		140.8	144.0	171.6	184.1	206.3	183.8	206.3
Labour costs		(41.3)	(43.1)	(49.9)	(55.0)	(62.2)	(61.3)	(62.2)
Provider fees		(24.0)	(23.5)	(27.4)	(29.3)	(31.9)	(29.3)	(31.9)
Facility and occupation costs		(7.7)	(9.0)	(10.4)	(12.0)	(13.3)	(11.9)	(13.3)
Consumables and supplies		(8.0)	(7.0)	(9.8)	(9.9)	(11.5)	(9.9)	(11.5)
Other operating costs		(20.2)	(19.5)	(22.5)	(22.6)	(24.4)	(27.8)	(24.4)
Total expenses		(101.2)	(102.1)	(120.0)	(128.8)	(143.3)	(140.2)	(143.3)
EBITDA		39.6	41.9	51.6	55.3	63.0	43.6	63.0
Depreciation		(4.3)	(5.1)	(5.9)	(6.4)	(7.7)	(6.4)	(7.7)
Amortisation		(1.3)	(1.0)	(1.1)	(2.1)	(1.6)	(2.8)	(1.6)
EBIT		34.0	35.8	44.6	46.8	53.7	34.4	53.7
Net Interest expense		(7.1)	(8.5)	(9.7)	(9.2)	(9.2)	(21.9)	(9.2)
Profit before tax		26.9	27.3	34.9	37.6	44.5	12.5	44.5
Income tax expense		(7.8)	(8.0)	(10.2)	(11.0)	(13.1)	(3.9)	(13.1)
NPAT		19.1	19.3	24.7	26.6	31.4	8.6	31.4
NPATA	3	19.8	20.0	25.4	27.3	32.1	9.3	32.1

Table 2: Virtus Health business metrics

June year end	Pro Forma Historical Results			Pro Forma Forecast Results		Forecast Statutory Results	
	FY2010	FY2011	FY2012	FY2013	FY2014	FY2013	FY2014
Number of IVF Cycles – Virtus	13,109	12,575	13,816	14,124	15,409	14,124	15,409
Number of IVF Cycles – New South Wales / Victoria / Queensland ³	30,305	28,829	31,456				
Implied Virtus market share – IVF Cycles (%) ⁴	43.3%	43.6%	43.9%				
Average number of Fertility Specialists	61.5	65.0	75.0				
Average number of Virtus' IVF Cycles per average number of experienced contracted Fertility Specialists ^{5,7}	212	202	210				
Average number of Virtus' IVF Cycles per average number of new contracted Fertility Specialists ^{5,7}	13	27	73				
Average Total Revenue per IVF Cycle (\$)	10,741	11,453	12,420	13,034	13,389	13,013	13,389
Labour as a % of revenue	29.3%	29.9%	29.1%	29.9%	30.2%	33.3%	30.2%
Provider fees as a % of total revenue	17.0%	16.3%	16.0%	15.9%	15.5%	15.9%	15.5%
EBITDA growth		5.8%	23.2%	7.2%	13.9%		37.0%
EBITDA margin	28.1%	29.1%	30.1%	30.0%	30.5%	23.7%	30.5%
EBIT growth		5.3%	24.6%	4.9%	14.7%		45.9%
EBIT margin	24.1%	24.9%	26.0%	25.4%	26.0%	18.7%	26.0%
NPAT growth		1.0%	28.0%	7.7%	18.0%		204.9%
NPATA growth		1.0%	27.0%	7.5%	17.5%		191.8%

At time of listing the group was carrying \$144 million of debt, courtesy of private equity's preferred use of leverage when in ownership. As such, not only is Quadrant walking away with the lion's share of new capital raised, as well as, picking up a pre-float dividend payment of \$31 million, it has also asked new shareholders to pay off the group's debts. Under this scenario, new investors are taking on the extra risk of backing a new business, operated by a new management team, with a highly geared balance sheet, operating in an industry highly susceptible to regulatory change.

Management, fertility specialists and competition

Despite these shortcomings, the business offers enough attractive features to warrant an investment. Management led by CEO Sue Channon is an unknown quantity in the public arena although her involvement with Virtus Health stretches back to 2004, where she led the NSW fertility clinic operations and co-ordinated the group's geographical expansion. Channon starts her public life with over 30 years of healthcare experience, on a base salary of \$465,000 and a shareholding of 353,044 shares, valued at \$2 million. CFO Glenn Powers has worked alongside Channon since 2008 and has overseen the acquisition and integration of the group's expansion into Victorian and Queensland.

The largest stakeholders in the business are the fertility specialists. On listing they will collectively hold 24%. Of the issued capital with escrow provisions in place covering a portion of each specialist's shareholding. As we noted earlier, these contracted specialists are critical to the business's long term success and in order to

provide incentives to both existing and new specialists, the company will grant options on an annual basis should benchmarks be met. In crude terms, the IVF specialists are to complete 50 cycles in a financial year before being considered with future grants subject to 50 cycle increments. So as the number of IVF cycles performed rises so does the benchmark rise in order to earn additional options. Options granted are valued at \$258,000, while the actual number of shares offered takes into account the prevailing share price at the time. As such in order for the options to vest profitability, not only does the specialist need to maintain a high percentage of completed annual IVF cycles, they also require the share price to rise.

Perhaps a key strength for the group is its competitive market position. The Australian IVF industry is relatively concentrated with close to 75% of the clinics operated by one of four corporate owners. In total there are close to 110 fertility clinics with Virtus Health operating the largest number totaling 33, followed by Health Bridge with 19 clinics, Genea operating 14 and City Fertility controlling 9. Importantly, the contractual relationship that exists between the fertility specialists and the clinics acts as a significant barrier to new entrants.

CEO Channon has made no secret of the fact that Virtus Health will look to expand beyond its current operations. Further options under consideration include expanding into new states including South and Western Australia as well as offshore into New Zealand and parts of Asia.

The group is conscience of the opportunity that currently exists, particularly patients living in the less affluent regions of each state of operation. This has resulted in a low cost IVF model, branded The Fertility Centre (TFC). To date, there are three centres in operation, one in each state and the aim is to offer limited services at a lower cost. Should the patient require a higher level of service, the opportunity exists to visit a full service clinic.

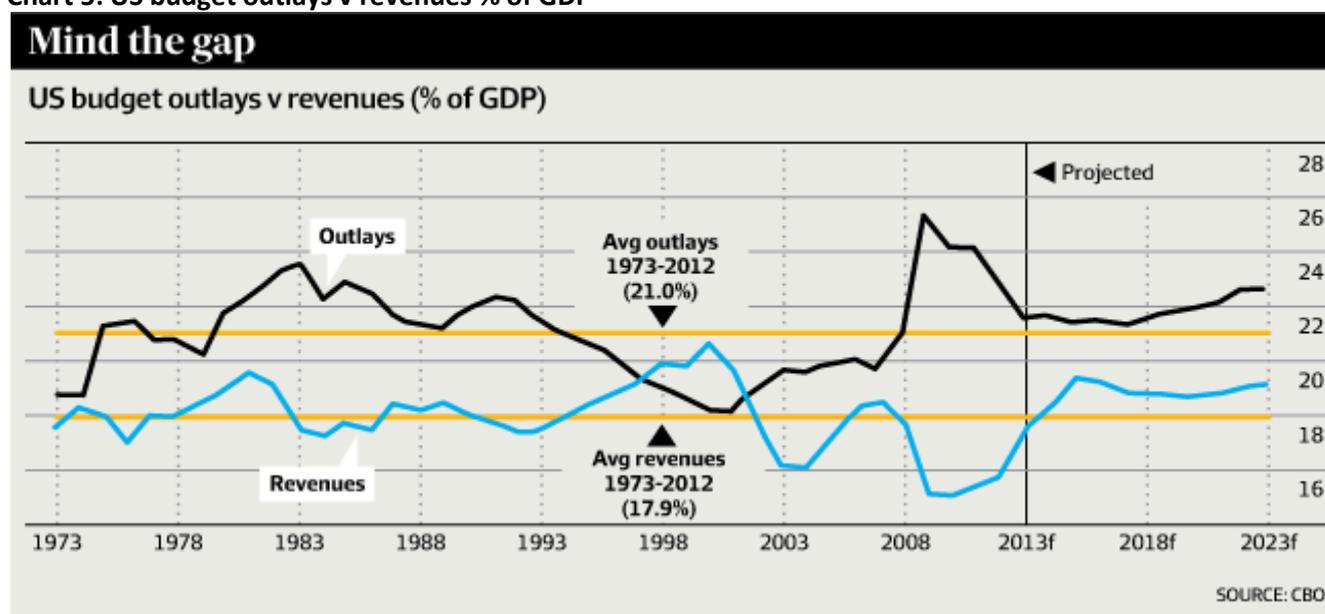
Summary

Virtus Health taps into a market that offers couples unable to conceive naturally with options. As a result IVF treatment has become a standard of treatment that has overcome both economic and regulatory challenges. While the company appears not to possess any significant advantage over its rivals, we would argue that business scale and industry reputation places it in a strong position to succeed. We remain wary that private equity may have sold us a lemon but on the evidence thus far we see reasons for feeling upbeat on Virtus Health's long term prospect. Since listing on 11 June the shares have enjoyed a positive start and ended the year trading at \$6.45, representing a gain of 13.6% on its listing price. *SFM*

US on the mend.

Back in 2011 we wrote in our December quarterly report, that despite the ongoing upheaval in world markets, we remained positive on the US market, titling our article "Why we are bullish on the US economy". Fast forward and the following picture as depicted in **Chart 5** has economists once again re-modeling their numbers in determining the US economy's direction. In 2009, US budget outlays outpaced revenues by some 10% of gross domestic product, with an annual deficit exceeding \$US1 trillion.

Chart 5: US budget outlays v revenues % of GDP



In more recent times, this deficit has reduced, and some are now suggesting the fall is happening too fast, too soon. As the blue line in **Chart 5** edges closer to the black line, Congressional Budget Office estimates that the US deficit could shrink to as a low as 2.1% of GDP by 2015. Despite the political paralysis, the Government has proved remarkably successful at slashing the deficit through a variety of tax increases and cuts in domestic and military programs. What has many concerned however is that this is being achieved despite the US unemployment rate remaining high at 7.5%.

Beyond the short term, deficits are expected to continue, but considering the extent to which the US Government has so successfully reduced the deficit in recent times, this script is still to be written. Overall, the figures demonstrate how the economic recovery has begun to refill the government’s coffers and how quickly circumstances can change for the better.

This is best reflected by Standard & Poor’s credit rating for the US improving from negative to stable. Having cut the US AAA ranking in August 2011, the ratings agency sees improvement on the horizon, noting that “We see some improvement lately in terms of moving, if gradually and hesitantly, but nonetheless towards fiscal consolidation. The US economic performance will match or exceed that of its peers in the coming years. We forecast that the external position of the US on a flow basis will not deteriorate.”

The portfolio is positioned for an improving US economy, with a number of the Fund’s holdings primed to benefit from a stronger earnings profile and assisted by a weakening Australian dollar. **SFM**

Investor day

During the quarter we attended a number of investor day briefings. Not all companies undertake such an event, however if done well, it is a worthy exercise, as it provides investors with an opportunity to meet management and more formally consider the merits of the business. To this end we can make the following comments on our most recent investor days that included the following businesses.

Aristocrat Leisure (ALL)

We attended gaming operator Aristocrat Leisure's investor day during March keen to learn more about the group's transformation program under the leadership of CEO Jamie Odell. When Odell first joined the business as CEO in February 2009, he spoke of the need to make changes. Words like strategic review, rightsizing, 3 to 5 year turnarounds, are terms that we approach with extreme caution. In short, we were unsure on a number of fronts despite our positive view towards the Aristocrat brand.

Three years on and the results are beginning to flow. The Fund made its first investment in the group during 2012, post the company's capital raising and once our initial reservations were addressed. In our opinion, the most important developments undertaken thus far revolve around personnel changes and a re-focus on what made Aristocrat a force within the industry, delivering the best game content. On this score, Odell has assembled what he and his team considers to be the best creative and technical talent within the industry. On this point investments have been directed to building gaming studios located closer to the key US market.

In his closing comments Odell outlined the key business drivers as listed below;

1. Business returns – an emphasis on delivering sustainable profits thereby delivering sustainable returns.
2. Technology – enable and deliver games although regulation will control rollout.
3. Talent – look beyond our shores to attract the best talent, make the appropriate long term investments.
4. Segments – focus on market segments where the company has the skills to compete successfully.
5. Share – identify core markets and take market share.
6. Content – invest to stay ahead of the curve and remaining relevant to the end consumer.

During May, Aristocrat unveiled its first half result ending March, having changed the group's financial year end to September, as it more closely aligns to the key US market buying cycle. A solid result was delivered, representing the group's fourth consecutive year of profit growth. Revenues were up and Odell noted that the end of the original turnaround window in 2014 was fast approaching.

Table 3 provides a quick snapshot of the group's earnings among the three key markets of Australia, North America and the Rest of World operations. Importantly, while earnings before interest and tax remained relatively unchanged at \$75.3 million, net profits rose 12% to \$53 million, largely assisted by an almost halving of the group's interest bill.

Operationally most pleasing were the improvements made in the group's key North American operations. In US dollar terms, revenues rose 12% to \$190.3 million, while segment profits kept pace rising 13% to \$69.2 million. The group's installed base of participating machines rose 8.5% to 6,922 on an average fee per day revenue share of \$40.80. In short, along with the group's Oasis systems business, annuity type revenues now represent

on our assessment, approximately 60% of revenues, partly fulfilling Odell's desire to build more sustainable earnings streams.

Table 3: Aristocrat half year results march 2013

A\$ million	HY13	HY12
Segment revenue		
Australian & New Zealand	95.5	102.4
Americas	196.0	179.6
Rest of World & Japan	91.7	132.3
Total segment revenue	383.2	414.3
Segment profit		
Australian & New Zealand	40.1	42.8
Americas	71.2	61.6
Rest of World & Japan	30.5	42.4
Total segment profit	141.8	146.8
Unallocated expenses		
Group design & development	(55.5)	(54.6)
Foreign exchange	0.9	(2.1)
Corporate	(11.9)	(13.9)
Total unallocated expenses	(66.5)	(70.6)
EBIT	75.3	76.2
Interest	(6.0)	(11.5)
Profit before tax	69.3	64.7
Income tax	(16.1)	(17.0)
Profit after tax	53.2	47.7

Lastly, renewed confidence in the business has led the board to return more to investors with the interim dividend increasing from 4 cents to 7 cents. Aristocrat is on track to earn \$105 million in profits this year, however this figure should be considered in light of the approximately \$250 million earned in 2007. There is still much to do and while Odell may have assembled the best industry talent there is, the results are still to come. We remain on board and will follow the group's progress with interest.

Fletcher Building (FBU)

The company held its investor day during May in the basement of a Sydney hotel. The bland surroundings were perhaps a reflection of a new management team intent on maintaining a low profile and a strong cost focus to make up for past mistakes. CEO Mark Adamson, appointed during 2012, spoke of the enormous task at hand. His opening line perhaps best summed up the Fletcher Building business, "It is a complex beast".

And that complexity is largely due to previous CEO Jonathan Ling's acquisition spree during boom conditions. The board acknowledged as much when thanking Ling on his retirement noting that at "As chief executive, Jonathan has overseen two large acquisitions that have nearly doubled the size of Fletcher Building. Just as significantly he has successfully steered Fletcher Building through one of the worst economic downturns in recent times.

The company's sound financial position and the strength of its management team are fitting testament to Jonathan's leadership".

Some shareholders may disagree with that assessment judging by the numbers outlined in **Table 4**. While the group is certainly larger as a result of both the Formica and GE Crane acquisitions in 2007 and 2011 respectively, the same cannot be said of profits and the returns generated on capital employed. In fact, on any proper assessment shareholders have suffered badly from a series of business mis-steps to put it kindly.

Table 4: Fletcher Building historical financial summary

\$NZ 'M	FY12	FY09	FY06	FY03
Revenue	8,873	7,103	5,520	3,221
Operating profit	403	159	675	331
Net profit after tax	185	(46)	379	168
Return on funds %	7.3	3.4	26.1	24.4
EPS (c)	27.2	(8.7)	81.3	43.4
DPS (c)	34.0	38.0	40.0	19.0

Having given Fletcher's a wide berth since its spinoff from the Fletcher Challenge group in 2001, our interest was piqued with the appointment of Adamson, following his successful restructure of the Formica business during a period of extreme market upheaval.

Our assessment on management thus far is positive and deserving of further analysis. Importantly, we don't underestimate the enormity of what Adamson is aiming to do, particularly when you consider the sheer scale of the business and it's many moving parts - a NZ\$9.0 billion building materials business, operating from multiple global locations and employing some 19,000 staff. At its core, the new Fletcher Building business will focus on removing layers of duplication and introducing a central unit, aptly named FB Unite to drive greater efficiency and support business development. Equally important is the desire to drive scale within each of the business units without relying on acquisitions.

Adamson, makes no apology that the new Fletcher Building needs to perform in any business cycle, invest and embrace technology to streamline operations and remove obstacles that prevent operational excellence. The turnaround is expected to take the typical 3 to 5 years but management has been prepared to put some numbers on the table. Under FB Unite, some NZ\$75-NZ\$100 million in savings are expected to flow from 2015 onwards, although the company needs to invest upfront to achieve those returns.

When compared to the 2013 company earnings before interest and tax guidance range of NZ\$560-NZ\$610 million, it is clear how significant and extensive the changes are likely to be. We will end where we started, noting that Fletcher Building is both a complex business operating in a cyclical sector of the market. That said, CEO Adamson is a breath of fresh air, who pulls no punches in his assessment of what needs to be done and what will be done. Mark this stock down as one to watch.

New News Corp (NNC) and Fairfax Media (FXJ)

These organisations operate at different spectrums of the media landscape. While News Corp has become one of the world's most dominant media operators, Fairfax Media has remained local. One has a market worth valued at \$76 billion, the other \$1.3 billion. It is no secret that when one speaks of media these days it is in the context of whether it operates under the banner of old media or new. For this we can thank the internet, a wave that has cast aside the traditional median of print publishing and exposed the vulnerability of an industry as it struggles to adapt.

News Corp has chosen to adapt by splitting the business in two. Ironically the new News Corp as it is now known, houses a collection of the traditionally old media assets including print publishing and a mix of newer ones such as pay television operator Fox Sports. In contrast, the old News Corp has been renamed 21st Century Fox and is primarily anchored by the group's cable and satellite pay television operations both in the US via the Fox Network brand and offshore through the various Sky operations in Italy, Germany and the UK. To this we can add the remaining assets of film and US television as well as a pile of cash and long duration debt.

Not surprisingly investors are grappling with how to value the new News Corp (we're still grappling with the name chosen), since it remains largely exposed to print revenue. **Table 5** below outlines the revenue and earnings of the group as it would have applied in 2012. Clearly old media comprising news publishing contributes the bulk of revenues and profits. The addition of digital assets such as REA Group and local subscription based television operator Foxtel (50%) and Fox Sports adds appeal but doesn't address the concern amongst investors regarding the ongoing structure issues facing print.

Table 5: New News Corp proforma earnings 2012

Segments	Brands	Revenue \$US'M	EBITDA \$US'M
News Information	Wall Street Journal Australian Sun	7,058	939
Cable Network Program	Fox Sports	486	131
Digital real estate	Listed REA Group	286	129
Book Publishing	Harper Collins	1189	111
Other	Amplify (start up) corporate expenses	121	(189)
Total Group		9,140	1,124
Associates*	Foxtel (50%)	1,200*	338*

* Actual earnings 9 months to March 2013

In contrast, Fairfax Media's future is more precarious. While the group's balance sheet is in far stronger shape with net debt levels now under \$100 million, the same cannot be said of revenues and profits. At the group's investor day CEO Greg Hywood spoke of the ongoing challenges his management team faces. During 2012 the Fairfax of the Future program was unveiled, a \$251 million savings program in an attempt to address the company's structural issues. Printing plants were to close and 20% of the group's 10,000 workers would lose their jobs, many included career journalists.

However, the difficulty in all this is in knowing where the bottom is and this is precisely the issue that confronts management today. An industry in transition requires business to constantly adapt and in announcing a further \$60 million of cost savings at investor day, Hywood was highlighting the enormity of the task.

In the past, papers were all about classifieds - jobs, homes and cars, because it was the classifieds that made the money. Today, Fairfax no longer has that edge. By failing to counter the online upstarts like SEEK and Carsales years ago, the company is now aiming to reinvent itself as it moves the business into the digital world. Future revenues will be sourced from three areas, subscription, advertising and digital transactions. But for all of management's best intentions, the leaking of revenues from print to online continues uninterrupted and with so much still riding on print revenues it is hard to see how Hywood can stop the inevitable.

It would seem that if Hywood his true to his word, that Fairfax will not use profits from good businesses to subsidise loss making businesses, then at some point in the future it is inevitable that the printing presses will be turned off for good. At that point the group may have completed its transition but at what cost to revenues and profits remains the big unknown, suffice to say that the numbers are likely to be significantly lower than the case today.

In summary, the challenges confronting the media industry are real and ongoing. Despite the appearance of something new, we remain wary of venturing in and will look to give the new News Corp a wide berth for now, while Fairfax Media continues to languish in the too hard basket.

NIB Holdings (NHF)

Listed since 2007, health insurer NIB has built up considerable credibility among its investors by sticking to its core business and undertaking sensible expansion. CEO Mark Fitzgibbon and CFO Michelle McPherson are a strong duo who have steered the ship thus far. The investor day was a reminder that management aim to be as transparent as possible when discussing the business and the health insurance industry in general.

As Fitzgibbon sees it, the group doesn't have a sustainable competitive advantage but makes up for it by being nimble and at the forefront of industry change. So while many may view NIB as just another health insurer, Fitzgibbon sees NIB as a finance company, helping customers transact for a whole range of healthcare options. As **Table 6** highlights, both Australia and New Zealand's health outlay is significant and rising. It appears therefore inevitable that with an increasing health spend, the funding onus will shift from the government to the private sector.

Table 6. Health statistics Australia and New Zealand

	Australia	New Zealand
Gross Domestic Product (GDP)	A\$1,500b	A\$175b
Population	23m	4.4m
Number of insured people	10.8m (47%)	1.3m (30%)
Inflation	2.5%	0.9%
Unemployment	5.5%	6.2%
Health spend (% of GDP)	9.3%	10.5%
Health spend	A\$130.3B	A\$16.7b

NIB's strategic game plan is to wrestle more of the business from competitors as governments look to relinquish their traditional funding role. While this will provide excellent options to grow, customers are having to pay more, with some reducing on their cover in order to make ends meet. At the same time, the growth of

online comparator sites like iselect and choosi are leading to higher churn rates within the industry, as members look to grab the best deal.

In recent years this has led to higher levels of lapse rates, circa 10% and management clearly admit that more must be done to address this important issue. A greater level of resources has been earmarked and the group is now proactively engaging with both present and past members to either maintain or recapture their business.

Overall Fitzgibbon outlines a number of key business objectives including;

1. Remain focused on the youth market and extending into the over 55 years age bracket.
2. Extend into geographic regions as illustrated by the group's recent move into New Zealand
3. Grow international inbound business for both workers and students.
4. Provide a one stop fee for service medical travel insurance product.
5. Address the costs of doing business.

Fitzgibbon is very confident of growing the group's top line with an innovative range of products and services. Presently NIB captures about \$1.3 billion in premiums each year, representing a market share of 7%. The two main competitors remain Medicare Private and BUPA who collectively control some 65% of the health premiums market. The impending sale of Medicare Private and a likely change in the Federal Government will refocus attention on this sector.

An investment NIB is not without risk. That said, NIB operates in an industry that has a number of favourable tailwinds, none more so than the need for individuals to provide for their own health cover needs. The Fund has an investment in NIB and our meeting with management reinforced our confidence in both their strategic endeavours and the underlying industry dynamics. *SFM*

Sticking to the facts – federal budget

Treasurer Wayne Swan delivered a budget in May that has left many bamboozled by the extent to which the expected surplus that was promised has turned into a resounding deficit. The Government argues that a series of external factors conspired to negate the steps taken to deliver the promised surplus. Unfortunately, for the ordinary voter trying to discern fact from fiction, this is not an easy task, since politicians are experts in the art of spin. Treasurer Swan has gone to great lengths to explain that the missing surplus is largely due to the strength of the Australian dollar. Manufacturing has been hammered and revenues lost, much of which was required to pay for the billions invested elsewhere. But before we venture down the path of the missing surplus, let's for a moment return to the facts. Wikipedia defines the word fact as something that has really occurred or is actually the case. Governments struggle to deal with facts because it always involves discussing the truth. So to avoid any confusion, reproduced below in **Table 7** are the Government's actual budget positions since 1995.

To put some timelines into perspective, The Liberal Government took office in 1996 with John Howard as Prime Minister for the period 11 March 1996 until 3 December 2007. The Labor Party Government took office in December 2007 and was initially led by Kevin Rudd as Prime Minister until Julia Gillard took over as the 27th Australian Prime Minister on 24 June 2010. In the last few days of June, Kevin Rudd regained the leadership which saw the departure of former Treasurer Wayne Swan, a position he held since the Labor Party came to office in December 2007.

Table 7: Federal Government budgets 1995 – 2017

Budget Year	Receipts \$m	Payments \$m	Surplus (Deficit) \$m	Net Debt (Net Surplus) \$m	Net Interest Payments \$m
1994-95	113,458	127,619	(14,160)	83,492	7,292
1995-96	124,429	135,538	(11,109)	95,831	8,861
1996-97	133,592	139,689	(6,099)	96,281	9,489
1997-98	140,736	140,587	149	82,935	8,279
1998-99	152,063	148,175	3,889	72,065	8,649
1999-00	166,199	153,192	13,007	53,869	7,514
2000-01	182,996	177,123	5,872	42,719	6,195
2001-02	187,588	168,655	(1,067)	38,180	5,352
2002-03	204,613	197,243	7,370	29,047	3,758
2003-04	217,775	209,785	7,990	22,639	3,040
2004-05	235,984	222,407	13,577	10,741	2,502
2005-06	255,943	240,136	15,807	(4,531)	2,303
2006-07	272,637	253,321	19,316	(29,150)	228
2007-08	294,917	271,843	23,074	(44,820)	-1,015
2008-09	292,600	316,046	(23,446)	(16,148)	-1,196
2009-10	284,662	336,900	(52,238)	42,283	2,386
2010-11	302,024	346,102	(44,078)	84,551	4,608
2011-12	329,874	371,032	(41,158)	147,334	6,609
2012-13 (e)	350,410	367,286	(16,876)	161,603	8,238
2013-14 (e)	375,993	391,198	(15,205)	178,104	7,835
2014-15 (e)	401,171	409,149	(7,978)	191,552	8,405
2015-16 (e)	428,931	424,969	3,962	191,172	9,752
2016-17 (e)	453,642	443,748	9,894	185,662	7,726

Source: Historical Australian Government Data

Now to the casual observer the figures in the reproduced table lead to a number of clear outcomes without the need to rely on external commentators confusing the facts. Firstly, Government receipts have continued to grow, despite the onset of the global crisis that started in 2008. Since 1995, this number has risen from \$113 billion to \$330 billion by 2012. Similarly, payments have climbed from \$128 billion to \$371 billion over the same period.

Secondly, since taking office in 1997, the Liberal Party have delivered surpluses in every year, except 2001-02 where a \$1.1 billion deficit was recorded. In contrast, the Labor Party have failed to register a surplus despite the promise and a commitment to do so.

As a consequence Australia no longer enjoys the legacy of a strong balance sheet. In the space of six years Australia's net debt position has reversed from a net surplus of \$44 billion to a net deficit of \$147 billion and counting.

So these are the facts. No matter how you spin it or recast the numbers, the inescapable conclusions are pretty clear. Receipts have gone up and not collapsed despite Ex-Treasurer Swan's best efforts to convey a different view. Payments however have gone up even faster and for that we are now left with rising deficits and higher debts. With that, the Government is now incurring an interest bill that is set to hit \$8.2 billion this year as compared to receiving interest of \$1.0 billion when it took office.

Discussions on whether this Government took the most prudent course of action during and post the global crisis are open to debate but one thing is clear, if company directors are held to account for misleading the facts then the same should apply to those that hold the highest office in the land. There is nothing wrong in charting a course and sticking to it, even if many disagree with the direction taken. What is not acceptable is the extent to which one is prepared to spin the truth when the facts are indisputable. *SFM*

Company visit diary June Quarter 2013

April

MIN	Mineral Resources UBS conference meeting	10/04/13
NVT	Navitas UBS conference	10/04/13
AAX	Ausenco UBS conference meeting	10/04/13
SUL	Super Retail Group UBS conference meeting	10/04/13
MYX	Mayne Pharma Group UBS conference meeting	10/04/13
IFL	IOOF Holdings UBS conference meeting	10/04/13
FXL	Flexigroup UBS conference meeting	10/04/13
PXS	Pharmaxis Q3 conference call	11/04/13
FGE	Forge Group UBS conference meeting	11/04/13
MRM	Mermaid Marine Australia UBS conference meeting	11/04/13
SYD	Sydney Airports full year results presentation	15/04/13
VRT	Virtus Health pre IPO meeting	19/04/13
TRS	The Reject Shop business update	24/04/13
RMD	ResMed Inc. Q3 conference call	26/04/13
VRT	Virtus Health management meeting	29/04/13
MNY	Money3 Corporation conference meeting	29/04/13
SIV	Silver Chef conference meeting	30/04/13

May

SAI	SAI Global macquarie conference	01/05/13
SKE	Skilled Group macquarie conference	01/05/13
OSH	Oil Search macquarie conference	01/05/13
SYD	Sydney Airport macquarie conference	01/05/13
AUB	Austbrokers Holdings macquarie conference	01/05/13
RWH	Royal Wolf Holdings macquarie conference	01/05/13
RCR	RCR Tomlinson macquarie conference	01/05/13
IFL	IOOF macquarie conference	01/05/13
TOX	Tox Free Solutions macquarie conference	01/05/13
ARP	ARB Corporation macquarie conference	01/05/13
AGK	AGL Energy macquarie conference	01/05/13
CTX	Caltex Australia macquarie conference	02/05/13
IIN	inet macquarie conference	02/05/13
WOR	WorleyParsons macquarie conference	02/05/13
FBU	Fletcher Building macquarie conference	02/05/13
COH	Cochlear management site visit	06/05/13
JIN	Jumbo Interactive conference call	07/05/13
NEA	NearMap management meeting	07/05/13
DMP	Domino's Pizza Enterprises management meeting	13/05/13
SYD	Sydney Airport annual general meeting	16/05/13
GEM	GE Education management meeting	16/05/13
WOR	WorleyParsons annual general meeting	17/05/13

SOM	Somnomed management meeting	20/05/13
FBU	Fletcher Building investor day	22/05/13
FPH	Fisher & Paykel Healthcare full year results	23/05/13
TNE	Technology One management meeting half year	26/05/13
ALQ	ALS full year results meeting	27/05/13
PXS	Pharmaxis management meeting	28/05/13
ALL	Aristocrat Leisure half year results meeting	29/05/13

June

COH	Cochlear market briefing	03/06/13
SRX	Sirtex Medical site visit	04/06/13
NWS	News Corp investor day	05/06/13
FXJ	Fairfax Media investor day	06/06/13
OTH	Onthehouse Holdings management meeting	12/06/13
NHF	NIB Holdings investor day	14/06/13
STX	Sirtex Medical UBS health conference	18/06/13
FPH	Fisher & Paykel Healthcare Corporation UBS health conference	18/06/13
RMD	ResMed Inc. UBS health conference	18/06/13
AUB	Austbrokers Holdings site visit	20/06/13

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