

Dear Reader,

Please find attached our September 2008 Quarterly Investor Report for the Selector Fund.

Over the past quarter, global financial markets have again been rocked. Huge volatility persisted. Fear and panic continued.

Our research is aimed at trying to dodge the “landmines” highlighted in our December 2007 Quarterly Report. In doing so, we also aim to uncover some great businesses that we hope to hold well into the future.

Over the following pages we have attempted to shed light on how we see the world unfolding. We have also provided additional insight into the recent reporting season relative to the collection of businesses held by the Fund.

We don't underestimate the global and domestic challenges that continue to unfold. And we believe the importance of patient investing carries even greater weight during these times. We remain focused on concentrated, long only, patient investing.

We hope you are pleased with the results for this quarter in light of extreme market conditions.

Finally, in these difficult financial times, we continue to see opportunity, so please do not hesitate to contact either Tony Scenna or Corey Vincent.

Regards

Tony Scenna
Corey Vincent
Selector Funds Management

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FUND PERFORMANCE

It was an important quarter on several fronts.

Firstly, the September quarter included the 2007 - 2008 full year reporting season. This provided a fundamental guide to company performances, enabling the market to focus more on the facts and less on the fiction.

Secondly, the quarter recorded many negative precedents. Arguably some of the strongest headwinds felt in many decades.

Focused stock selection and patient investing were rewarded by some strong full year results.

The Selector Fund out performed the All Ordinaries Accumulation Index by 15.16%.

The Selector Fund gained 3.27% while the All Ordinaries Accumulation Index recorded a negative 11.89% return. See Statistics page 23. *SFM*

Big Picture

Cow in the Ditch

Countless words have been written about the “credit crisis”, including armageddon, meltdown, panic and depression. The media is in overdrive. Unfortunately, most of this commentary is driven by dialogue focused on hindsight rather foresight.

While we are pretty convinced it is not the end of the world - even though the

papers would have you believe otherwise - late in the quarter we were stunned to see US three month Treasury notes trading on a 0.02% yield and in some quarters even negative yields. A negative yield implies investing \$100 to get less back in three months.

Under such conditions, confidence is all but gone. Counter parties no longer have trust in each other. Rumours lead to bank runs. Credit markets stop. Fundamentals don't apply. Stock markets tank.

“get the cow out of the ditch... make sure you do whatever it takes so the cow doesn't go into the ditch again.”

In the March 2005 edition of Fortune Magazine, Xerox CEO, Anne Mulcahy, said the best piece of advice she got came from a customer named Albert C Black Jnr, CEO of On - Target Supplies and Logistics.

Black said, “When everything gets really complicated and you feel overwhelmed, think about it this way. You gotta do three things. First get the cow out of the ditch. Second, find out how the cow got into the ditch. Third, make sure you do whatever it takes so the cow doesn't go into the ditch again.”

The key to the “credit crisis” is simple then. Get the cow out of the ditch. Second, stop it happening again. And we are pretty certain the US Federal Government is already working on the third.

According to Warren Buffett, the US\$700 billion Troubled Asset Relief Program (TARP) is a good bet. Buffett said he would be in “investing heaven” if he could fund the transactions at these rates and scale. That said, the US Government is not the “world’s best investor”, and this is a complicated program buying complicated assets.

Bill Gross, CEO of PIMCO, the world’s largest bond trader, simply wanted the public to understand this is a US\$700 billion investment.

Gross believed the TARP was required to repair the confidence loop. According to Gross, restoring confidence is the key to successfully completing the new capital raisings that are also required - we agree.

In essence, under the TARP, the US Treasury will borrow at 3% to buy distressed assets, at arguably the bottom of the market. These assets may ultimately generate yields of 10% plus. Gross claims the difference between the cost and return generated – the 7% to 8% spread - is an attractive equity type return for US tax payers.

Thankfully, Bill Gross has also applied some foresight to a debate that has been long on emotion.

“a lot of additional capital to be tapped”

Firstly, Gross suggests a TARP like program would gradually return confidence and stability to fragile markets. Secondly, it would inject

approximately \$45 billion of much needed new capital into the banking system. Thirdly, PIMCO estimates that the US banking system actually requires an additional US\$500 billion of new capital to recapitalise dangerously over stretched balance sheets.

That’s a lot of additional capital that needs to be tapped, hence the need for investor confidence in global financial markets.

In essence the US market requires another one hundred capital raisings of similar proportions to the now famous deal struck between Goldman Sachs and Warren Buffett. That’s a big drag on the markets and it ultimately means ongoing tight credit.

With or without the TARP, we believe a key theme for stock selection, and individual businesses, is the potential of dilutive capital raisings.

Make no bones about it, recapitalisation is a big and very real issue. It’s less talked about because it is harder to solve. And getting the next “100 deals” as suggested in our example is all about confidence. The result will be many mergers and probably more “shot gun marriages” like Bear Stearns, Merrill Lynch, Washington Mutual and Wachovia.

Recapitalisation goes hand in hand with de-leveraging.

De-leveraging is the selling of assets to pay down debt. Once assets are sold any gearing covenants exceeded or holes left

in balance sheets will require new capital.

The problem here is in the current climate very few assets are changing hands due to the evaporation of investor confidence. And with so few buyers, only the very well capitalised will earn a seat at any fire sale table.

Commercial property trusts are a prime example of the need to de-leverage.

With equity yields increasing as share prices fall, some property advisors believe yields on lower quality properties will need to approach 10% to see cashed up buyers participate. And with yields currently around the 6% - 8% mark, that implies additional pain for those with leveraged exposure.

“property trusts ... a bigger pile of debt relative to the reduced equity”

Pain aside, the bigger issue here is that when property trusts have gearing levels north of 60%, selling assets on 10% yields do not automatically result in a de-leveraged outcome. Rather it more likely leads to a drop in the unit value per security. In effect, the trust has a bigger pile of debt relative to the reduced level of equity held. And with reduced levels of equity, new capital is required just to keep gearing levels unchanged.

Any bad debts, some of which are inevitable of course, directly impact all

those banks funding the 60% plus gearing ratios. And as banks are forced to recapitalise their own balance sheets, they will in turn demand more security from owners to recapitalise existing property portfolios. This process can be vicious in its cycle and comes at an enormous cost to ordinary investors.

For our part, one of our key “roadmap” aims is to avoid precisely this scenario – where companies are forced to go cap in hand to raise expensive new capital during times of financial weakness.

More to the point, we want to hold businesses that have a sustainable business model - low capital intensive operations carrying little or no debt. For example, Flight Centre carries no inventory and holds significant levels of excess cash. Qantas on the other hand, has a constant need to buy new planes and is burdened with buckets of debt.

So back to the TARP. For all that has been said about it, the TARP is principally designed to get the cow out of the ditch. And, Hank Paulson, the US Treasury Secretary believes the TARP is big enough to cover most of the ditch. Once out, more action in the form of rate cuts, financial initiatives and re-regulation will be needed.

We take the view that the TARP provides the first tangible step towards returning confidence to the badly damaged global credit markets. Beyond that, the longer and less talked about process of recapitalising global balance sheets can begin.

The forces of de-leveraging and recapitalisation will play out over a considerably long period of time. Share markets on the other hand adjust to circumstances quickly and have historically led on the way down and bottomed when conditions look bleak.

SFM

Macro, where to from here?

In our *“Macro, where to from here? June quarterly report 2008*, we discussed the macro economic themes dominating financial markets.

Domestically we argued that inflation was less of a concern than weak economic growth. Today, we believe inflation is dead.

We noted that interest rate policy at 7.25% was too restrictive for an economy forecast to grow at less than 3%. And we concluded that the domestic interest rate cycle had peaked.

Yet even we were surprised by how quick Reserve Bank Governor Glenn Stevens back flipped on this one. We now see a series of domestic interest rate cuts, potentially becoming more aggressive if markets deteriorate further.

Last quarter, the oil price was centre stage. We argued that weak economic growth would translate to weak demand for oil. We also noted that the silver lining of a weak \$US was the resurgence of US exporters.

NSW... business growth is already at recession type levels.

However the benefits of falling interest rates (domestically), oil and commodity prices (globally) have been overshadowed by the re-freezing of credit markets and “bank runs” that have shattered confidence.

Two big macro trends stand out for us today.

The first is the break down in the confidence loop or want some term the “negative feedback loop”.

We already have spoken about US three month treasury yield and bank runs, both of which highlight a system-wide confidence breakdown.

And with the US President, US Treasury Secretary and US Federal Reserve Chairman warning of the imminent collapse of global financial systems it is not surprising that the “negative feedback loop” remains in tact.

The second key macro trend for us is GDP growth, or the lack thereof. This is a global and domestic issue. It is the reason we believe inflation well and truly on the back burner.

Domestically, the forecast in Australia is for sub 3% annual growth. This implies rising unemployment and contraction of business activity. And, if anecdotal evidence in NSW is any guide, business

growth is already at recession type levels.

Out in the real world, feedback we're getting from operators in the timber industry, property advisory groups, small engineering firm, surveyors and a medium sized architectural practise all point to rather bleak times ahead, that have worsened since June.

On the flip side, we note that retail sales bounced post June, as consumer sentiment picked itself up following the first 25 basis point rate cut in official interest rates back in September. And while Harvey Norman Chairman, Gerry Harvey, was calling for an additional 200 basis point rate cut, the Reserve Bank met him half way, cutting official cash rates by another 100 basis points early in October, setting them at 6.00%.

GDP weakness is a global theme. Even China has cut interest rates and relaxed some banking standards this quarter.

Ireland represents the worst of Europe. Its share market has fallen nearly 70% from its high point and trades at an average price to earnings ratio of less than 6 times.

From Greece to Germany, Governments are giving unprecedented guarantees to depositors.

As we write, the UK is mulling its own rescue package.

***“change the playing field
by changing the
regulatory environment”***

The US economy, which has been somewhat resilient to date, stumbled heavily in September. Auto sales have hit the wall. Non-farm payroll figures provided a negative surprise.

So where to from here? We will try to keep our views simple here rather than complicating matters further.

The “negative feedback loop” may have some time to run. Certainly de-leveraging and recapitalisation will be top of mind for some time.

But make no mistake, investor confidence will return, and markets will rally. And we believe the shift can be sharp, particularly when markets are priced for a worst-case scenario. And that is exactly what we have in global credit markets today.

Here we hazard a guess at a couple of potential turning points that could break the negative feedback loop.

Globally, whether we like it or not, markets are likely to see a concerted effort by all Governments to flood the banking system with cheap money. Furthermore, we expect further rate cuts.

Governments will no doubt go further down the recapitalisation process. Bailouts and new ways to invest public money are more than likely. To this end, the UK banking package will be an

interesting aside. Governments are adept at altering the playing field by changing the regulatory environment.

In particular, they have in their sights accounting standards that force assets to be marked to market. We consider this below. *SFM*

Regulation – a new world or a change of stripes?

After Enron collapsed, regulators pounced. They introduced the Sarbanes-Oxley Act of 2002 also known as the Public Company Accounting Reform and Investor Protection Act of 2002.

Regulators are surely set to pounce again. In fact, it is happening already. An example is Section 132 of the Emergency Economic Stabilization Act of 2008, approved by President Bush on the 3 October 2008.

Section 132 is titled "Authority to Suspend Mark-to-Market Accounting".

According to Wikipedia, mark-to-market is an accounting methodology of assigning a value to a position held in a financial instrument based on the current market price for the instrument or similar instruments.

For example, the final value of a futures contract that expires in nine months will not be known until it expires. If it is marked to market, for accounting purposes, it is assigned the value that it would currently trade on the open market. Today the Securities Exchange

Commissions (SEC) believes markets are "disorderly" so the rules should be changed.

Steve Forbes, Editor of Forbes Magazine has been shouting for "mark to market" accounting to be scrapped for some months. His cause was recently taken up by Newt Gingrich, former speaker of the United States House of Representatives from 1995 - 1999 and now Forbes magazine staff writer.

In a Forbes article on the 29 September 2008, Gingrich quoted William Isaac, Chairman of the Federal Deposit Insurance Corporation (FDIC) in the 1980's under President Reagan, who recently wrote in The Wall Street Journal,

"During the 1980's, our underlying economic problems were far more serious than the economic problems we're facing this time around. ... It could have been much worse. The country's 10 largest banks were loaded up with Third World debt that was valued in the market at cents in the dollar. If we had marked those loans to market prices, virtually every one of them would have been insolvent.

Isaac continues, *"But what do we do when the already thin market for assets freezes up, and only a handful of transactions occur at extremely depressed prices? ... The accounting profession, scarred by decades of costly litigation, just keeps marking down the assets as fast as it can."*

He concludes, *“This is contrary to everything we know about bank regulation. When there are temporary impairments of asset values, due to economic and market place events, regulators must give institutions an opportunity to survive the temporary impairment. Assets should not be marked to unrealistic fire sale prices. Regulators must evaluate the assets on the basis of their true economic value (a discounted cash flow analysis). If we had followed today’s approach during the 1980’s, we would have nationalised all the major banks in the country, and thousands of additional thrifts would have failed. I have little doubt that the country would have gone from a serious recession to a deep depression.”*

As in previous occasions, today’s credit crisis and the need to “mark to market” have resulted in forced asset sales. But all this may be set to change under Section 132.

Section 132 will restate the SEC’s authority to suspend the application of the Financial Accounting Standards (FAS) board statement No.157 if the SEC determines that it is in the public interest and protects investors.

FAS 157 is the “Fair Value Measurement”. It became effective post November 15, 2007, when it became clear that determining a “fair value” in a disorderly market was not possible. Precisely the situation we have today.

Further to this, is section 133 of the Act, titled "Study on Mark-to-Market

Accounting.” This is interesting, in that it requires the SEC, in consultation with the Federal Reserve Board and the Treasury Department, to conduct a study on “mark-to-market” accounting standards as provided in FAS 157. The study must review the effects FAS 157 has had on balance sheets and its impact on the quality of financial information made available.

Importantly section 133 requires the SEC to report its findings to Congress, within 90 days.

In addition, on 30 September, 2008 the SEC issued clarifications regarding the implementation of “fair value measurement” accounting. This was designed to help address concerns regarding the impact of “fair value measurement” on financial institutions holding Mortgage Backed Securities (MBS).

This guidance stated that forced liquidations are not indicative of “fair value” as this is not an "orderly" transaction.

Rather, the expected cash flows from such instruments are a more appropriate means of valuation, subject to applicable adjustments for default risks.

Yet under FAS 157, many companies, unable to offload their MBS’s have already suffered deep mark-downs (steep reductions) often impacting investors, even when cash flows from the securities, suggested a much higher value was warranted.

In short, the SEC has acknowledged the market for MBS are not "orderly" and "fair value measurement" standards should be more liberally applied to reflect the expected cash value.

The application of section 132 and 133 could conceivably make the TARP a non-event.

These rule changes may enable holders of troubled assets to hold to duration without any need to write down the asset value – or until markets reopen.

Importantly it can help break the negative feedback loop.

All pretty simple stuff really.

Restoring the balance sheets of financial institutions will go a long way to restoring investor confidence in the markets.

We have no doubt private capital has swelled up on the sidelines, while private investors have hoarded their cash. And at some point share markets will provide an exceptionally attractive home. The current across the board attractive valuations will assure this. *SFM*

Reporting Season and Portfolio

In our last quarterly update we gave an insight into some of the companies that make up the portfolio and the qualities that underpinned them. Below we continue along that theme with the remainder of businesses held.

And as we noted previously, it is our intent that in each of the businesses we seek to buy into, we look for the following investment qualities.

- ✓ Management team that can balance leadership skills with common sense
- ✓ Focus on a core business offering with scalable business qualities
- ✓ Attaining strong market leading position by embracing innovation
- ✓ Ability to grow from within (organic) aided by strategic acquisitions
- ✓ Investing where necessary, avoiding debt where possible
- ✓ Converting expectations into reality, revenues into high quality free cash flow
- ✓ Generating high returns on invested shareholder capital
- ✓ Keeping to an absolute minimum the release of new share capital
- ✓ Returning profits to shareholders via real earnings per share growth and dividends

Australian Wealth Management (AUW)

Australian Wealth Management operates in the financial services space, targeting, superannuation administration. Since listing in 2005, the company has openly pursued organic expansion and strategic acquisitions culminating with the merger with Select Managed Funds in 2006. As with many successful businesses, Australian Wealth has benefited from the considerable scale it now enjoys across the four core strands of its vertically integrated business model.

As CEO Chris Kelaher openly admits, the company's aim is to earn a slice of the fees on offer, across all facets of the financial services model, from administration, funds management, financial planning and trustee services.

At its core, Kelaher has targeted the superannuation industry and its attractive industry prospects to pursue growth.

Today, Australian Wealth services some 400,000 superannuation members while overseeing \$60 billion of Funds under Management, Administration, Advice & Supervision. On the earnings front, the metrics are just as impressive with operating profits of \$89 million on net operating revenue totalling \$190M, equal to operating margins of 47%.

The group's strong free cash flow status is accompanied by a complete lack of debt on the balance sheet and a dividend payout ratio sitting in the ninety per cent region.

While the group has not been immune from the financial market fallout, it possesses defensive qualities that place it in good stead to take advantage of opportunities which has been a hallmark of both Kelaher and the business.

Some Australian Wealth characteristics that align with our roadmap include;

- ✓ Strong market position in key selected business offerings
- ✓ Industry dynamics surrounding superannuation underpins business growth

- ✓ Consistent operating history / track record
- ✓ Growing annuity type revenue streams
- ✓ No net debt / excellent free cash flow
- ✓ Management large shareholders in the business

- ✓ Trading on historical PER 10.9 / Yield 8.7% fully franked

Resmed (RMD)

Allowing people to sleep has been the driving force behind the company and its founders, led until very recently by Chairman Peter Farrell.

Resmed was formed in March 1994 and listed in June 1995. However it was Peter Farrell's pursuit in 1989 to acquire certain technology rights relating to Continuous Positive Airway Pressure (CPAP), as well as its device business that got the ball rolling.

Many of us take sleeping for granted, but for a growing number of the population, the evidence is clear, that if left untreated, more alarming health conditions including diabetes, stroke and heart disease are likely.

Today Resmed, along with Respironics (acquired in December 2007 by Royal Philips Electronics NV for \$US5.1 billion), dominate the global sleep disordered breathing (SDB) market, by developing, manufacturing and distributing equipment to diagnose and treat respiratory disorders. At its most basic level the treatment of CPAP, is to

allow the delivery of pressurised air, typically through a nasal mask, to prevent the collapse of the upper airway lungs.

Globally the SDB market is estimated to be worth \$US2 billion, growing at 15% - 20% per annum, with current penetration at less than 10% in the US market and less than 2% in the rest of world markets.

With operations in 70 countries, Resmed have delivered stellar growth with sales rising from \$US274M to \$US835M over the past years to 2008. Equally impressive, the group's bottom line has surged from \$US46M to \$US134M. Financially the group is very well positioned with a net cash position of \$US183M and a strong focus on generating real earnings per share growth.

The hallmark of any great business is management's propensity to position the business for growth by making the necessary investments today. In this regard, Resmed's research and development budget spend of \$US59M during 2008 illustrates an ongoing commitment to lead. What is becoming increasingly clear to both the medical fraternity and more generally the public, is in order to function well, people need to enjoy healthy sleep. Fortunately Resmed appears well positioned, over the ensuing decade to deliver on these goals.

Some Resmed characteristics that align with our roadmap include;

- ✓ Leading global market position
- ✓ Operating in 70 countries / largely built on organic growth
- ✓ Industry dynamics underpins business growth
- ✓ Consistent and significant research and development investment to lead market
- ✓ Consistent operating history / track record
- ✓ Growing annuity type revenue streams
- ✓ No net debt / excellent free cash flow
- ✓ Management / shareholders in the business
- ✓ Takeover appeal

SEEK (SEK)

A relatively new addition to the portfolio, SEEK's business has shot to prominence as the structural migration of employment advertising from print to online continues unabated. SEEK's early move has caught traditional print players including Fairfax Media totally off guard.

In an article that appeared in The Australian on 30 August 2008, Fairfax Media's former CEO Fred Hilmer and current CEO David Kirk further highlighted the group's current plight.

CEO Fred Hilmer commenting on the missed opportunity to acquire a stake in SEEK in 2003.

"I found no media model for a broadsheet, classified-dependent newspaper organisation that would pull me out of the hole I found myself in at

Fairfax. In hindsight I should have seen that classifieds tend to gravitate to the leading site in any category...I should have done something other than try to compete head-to head.”

CEO David Kirk, in revealing the extent of the predicament confronting the company in classifieds at its latest annual profit briefing.

“We make no bones about the fact we do continue to see leaking out of the bottom of the bucket when it comes to lineage classified advertising and that will no doubt continue.”

Founded in 1997 by joint CEO’s Paul and Andrew Bassat, SEEK’s first mover advantage now has the group dominating with a 70% estimated share of a online market valued at \$200M and a total industry print and online classified market valued at \$700M. With only 30% of the spend currently taking place online and the trend likely to accelerate over the next three to five years, it’s little wonder Fairfax CEO Kirk is so concerned about the on-going leak from the group’s “rivers of gold”.

SEEK has also extended its interest in the online world via its push into the online training and education market in Australia as well as taking strategic investment stakes in leading international classified online market operators including Zhaopin (China), JobStreet Corporation Berhad (Malaysia) and Brasil Online Holdings (Brasil).

From a zero standing start, the group now generates revenues of \$210M and a

net profit after tax of \$76M. Operating margins of circa 50%, low capital expenditure requirements and strong free cash flows underpins the group’s quality offering.

Having hit a high of \$9.40 last November, the group’s current share price of \$5.10 has given us an opportunity to grab a stake in a business with attractive industry prospects trading at a more sensible price.

Some SEEK characteristics that align with our roadmap include;

- ✓ Strong brand awareness
- ✓ Market leading position / underpinned by excellent industry trends
- ✓ High barriers to entry
- ✓ Quality management team / major shareholders / interest aligned
- ✓ High margin / low capital expenditure requirements
- ✓ Investing in leading online operators
- ✓ Low debt levels
- ✓ Takeover appeal
- ✓ Trading at attractive valuations / 2009 forecast PER 17 / Yield 4.0%

ROC Oil (ROC)

It’s fair to say that of late, things haven’t gone that well for ROC or its shareholders. Despite a record run in oil prices and group operating revenue hitting new highs, the company’s dismal exploration run has resulted in the company spending a great deal of its free

cash flow with little in the way of success.

The sudden passing of founder and CEO Dr John Doran during the year and the group's earnings dilutive purchase of fellow oil and gas producer Anzon Australia have us questioning our long term investment in the group. That said, many of the qualities that we first identified in the business are still present today.

Management remain ultra conservative and speak openly and honestly to shareholders. From its origins in late 1996, ROC listed onto the exchange in 1999 with little in the way of producing assets. Today, ROC is producing at a rate of 10,000 barrels of oil equivalent per day (BOEPD) from six producing fields and in four countries. Post the Anzon acquisition, ROC will control oil reserves totalling 47 million barrels and a production profile that will start at 14,000 BOEPD and ramp up to 20,000 BOEPD by 2011 with the development of Anzon's existing Basker Mantra Gummy oil and gas project in Gippsland Basin, Bass Strait (40% interest & operator).

On the flip side, the Anzon acquisition will also see ROC's issued capital virtually double to 596 million shares with any ongoing exploration success now effectively diluted by half.

Despite these concerns, ROC's operational performance has been solid, accompanied by a balance sheet carrying

little in the way of debt and a combined gross revenue run rate post the Anzon acquisition of \$US475M per annum. Even with the enlarged capital base, the current market capitalisation of \$A540M looks extraordinarily cheap.

Some ROC Oil characteristics that align with our roadmap include;

- ✓ Conservative management team
- ✓ Disciplined, consistent, contrarian approach build largely on organic growth
- ✓ Strong cash flow / exploration funded from internal cash generation
- ✓ Low debt
- ✓ Individuals that we trust
- ✓ Compelling valuation

QBE Insurance Group (QBE)

The more one looks at QBE, the more one comes to the realisation that this is a first rate company run by a first rate, ultra conservative management team. And if the financial melt down has taught us anything, it is that these types of businesses need these qualities in abundance.

We added QBE to the portfolio during the recent share price collapse, having analysed the business over many years. What is most impressive about QBE and specifically the management team, is the internal acknowledgement of sticking to ones core strength and leaving everything else alone.

Following the company's near death experience post the 11 September 2001

terrorist attacks, the group hasn't looked back posting strong premium growth, augmented by a series of bolt on acquisition opportunities. Despite its Australian based status, the group is recognised as Australia's largest international insurance company with operations in 45 countries and ranked in the top 25 global insurance writers.

At its centre, QBE prides itself on the unique internal culture that has allowed the group to post excellent operating results within a disciplined risk effective environment. The results are plain to see, even if the world of insurance is never quite black or white.

Over the past ten years, QBE has posted a five fold increase in insurance premiums written, delivered insurance profits in all but one of those years, enjoyed growth in real earnings per share from 34.9 cents per share to \$2.24 per share, benefited from a jump in the group's stated net tangible asset from \$2.56 per share to \$6.83 per share and enjoyed a eight fold surge in cash flow to \$2.4 billion. These are impressive statistics in any period but even more so when you consider the damage that has befallen many of the group's competitors. While we are mindful that insurance operations are notoriously tricky to value, we have sufficient confidence in both the management team and the group's conservative regulatory standing to remain on board.

Some QBE Insurance characteristics that align with our roadmap include;

- ✓ Strong market leading position in niche product offerings
- ✓ Outstanding track record
- ✓ Conservative management team / internal succession planning a core discipline
- ✓ Shareholder interest paramount
- ✓ Organic driven business strategy / internally cash flow funded / opportunistic acquirer of businesses
- ✓ Conservative debt structure
- ✓ Strong regulatory position / A+ financial rating

NIB Holdings (NHF)

We first highlighted NIB Holdings in our September 2007 quarterly newsletter. At the time, we were having our first look at this health insurance group prior to its exchange listing.

NIB was incorporated in 1953 as a not for profit health fund for workers at the BHP Newcastle steelworks under the banner of the Newcastle Industrial Benefits Hospital Fund. It operated exclusively in Newcastle until 1975 when it amalgamated with the South Coast Medical Fund.

NIB expanded into Sydney in 1982 with the opening of its first retail centre. In 1992, NIB took another important step, getting the green light from regulators to expand into the new markets of Queensland, Victoria and the ACT. All this activity saw membership increase to a little over 160,000.

The turning point was the introduction of Government lifetime cover and rebates

in 2000. This single handily saved the industry and NIB's member numbers rose sharply beyond 200,000. As a result of these legislative changes, 2001 resulted in big profits as member premiums flooded in with no outflows, due to the 12-month "waiting periods" imposed on new members. The corollary was that 2002 resulted in big losses and the whole industry, perhaps wrongly, was tarred with the same brush. The industry is seen as being volatile at the profit line. Fitzgibbon believes this is the reason for the ongoing low level of professional interest and understanding.

Today NIB is the 6th largest Australian health insurance fund providing cover to 732,000 people via 365,000 policies. NIB commands 6-7% national market share and 18% of the NSW market.

However in recent months all attention has focused on the Federal Government's desire to change the Medicare formula with obvious negative impacts for the industry. While government intervention is a constant concern, NIB's market share and capital strength places the group in an extremely strong position.

Importantly, the group's most recent full year result reaffirmed the direction and strength of this health insurer with net underwriting margins of 4.4%, policy holder growth up 11% and a balance sheet free of debt, that boosts \$100 million of excess capital. Now trading at the group's stated book value (\$0.75), the board has undertaken the initial step of buying back 10% of the group's shares via an on-market process,

Some NIB Holdings characteristics that align with our roadmap include;

- ✓ Strong market leading position in niche product offerings
- ✓ Conservative management team / focused business objectives
- ✓ Organic driven business strategy / internally cash flow funded / opportunistic acquirer of businesses
- ✓ Conservative balance sheet
- ✓ Strong regulatory position
- ✓ On market buy-back of stock

Iress Market Technology (IRE)

A relatively new addition to the portfolio, Iress has worked itself into pole position within the local financial services community, providing share market and wealth management trading systems via its Iress platform offerings to stock brokers, investment managers and financial planners. Providing real-time data, analytics and news, the Iress platform in its many different offerings has become the market's system of choice and has allowed Iress to expand into related fields.

Importantly, the Iress model is subscription based and benefits from the largely fixed cost nature of the business. Management have continued to build content and service offerings over the past decade, resulting in expansion in both overseas markets including Canada and related fields including the financial planning industry.

While the strong equity markets of recent years have provided the group with the necessary back drop to post impressive growth, many of the qualities that have underpinned the company, will we believe continue to insulate them during the current, more turbulent period. In particular, high operating margins, tight control of operating costs, low capital expenditure requirements, strong cash flow and an ungeared balance sheet provide solid fundamental reasons supporting the business.

The fall in share price from a high of \$9.80 in June 2007 to current levels of \$5.20 goes some way to mitigating the risk to underlying earnings. Rarely do investors get the chance to buy monopoly type assets at attractive valuations but with investor panic the order of the day, such opportunities are becoming far more frequent.

Some Iress Market characteristics that align with our roadmap include;

- ✓ Strong market leading position in niche product offerings
- ✓ High barriers to entry
- ✓ Conservative management team / focused business objectives
- ✓ Organically driven business strategy / internally cash flow funded / opportunistic acquirer of businesses
- ✓ Conservative balance sheet / no debt
- ✓ Takeover appeal
- ✓ Trading on prospective 2008 PER 13.2 / Yield 5.9% *SFM*

Sub-Prime in plain English

So much has been written about the sub-prime debacle that it is difficult to separate fact from fiction or even understand what started this process and more importantly where it might all end.

But for what it is worth, we would like to add just a few paragraphs on our take of how things currently stand and how some of these events may play out.

Some years ago we invited the IMB Banking & Financial Services management team into our offices to discuss their operations. Our interest lay in the fact that they operated like any normal building society but with the added kicker that their shares (traded on an exempt market) were trading at extraordinarily lower valuations compared to their peers. Like any traditional building society, the IMB took in deposits and provided home loans.

However within the industry, the introduction of securitisation (the packaging, of any number of individual mortgages of various credit worthiness into a portfolio, subsequently sold off to external investors) allowed IMB and for that matter, the entire banking industry to record strong growth without the need to raise or retain extra capital. At the time it all sounded too good and we asked the folks from IMB, who wore the mortgage risk if borrowers defaulted. We were assured that even though IMB still retained some risk exposure to the portfolios sold, the chances of a

sufficient event trigger to warrant any such concern was small.

We chose not to invest in IMB for a whole host of reasons, the least of which related to the issue of securitisation. While the Australian banking industry appears to have weathered the storm extremely well, the information gleaned from our meeting with IMB now has far more relevance.

Fortunately, our financial regulatory system is of a sufficiently high standing that we are insulated from many of the issues facing overseas investors.

As Anatole Kaletsky wrote in *The Australian* on 16 September 2008, in order to understand what is happening to once mighty financial establishments, some understanding of the leveraging process is needed.

“Consider the following example: before the arrival of hyper finance, if a family wanted a \$100,000 mortgage they would go to the Halifax and simply borrow \$100,000. Now consider what would have happened in the new financial world. The family would have borrowed \$100,000 from Northern Rock, which would sell \$100,000 of bonds to hedge funds, which would buy these bonds with \$100,000 borrowed from Bear Stearns, their prime broker, which would raise this money by selling \$100,000 of commercial paper to Citibank, which would then borrow \$100,000 through their interbank market from Halifax.

The original borrower is still the same household and the ultimate lender is still

Halifax, but a \$100,000 mortgage has created \$500,000 of new debt. In theory, this entire chain of transactions could be squeezed like a concertina, back to the original \$100,000 loan between the borrower and Halifax and the total credit in the banking system could be reduced by 80 per cent, with very little effect on the real economy.

The reality would not, of course be quite so simple. The huge reduction in credit would leave the final borrower and the ultimate lender exactly where they were before, but all those intermediate transactions would vanish, with the related jobs and profits.

Moreover, many imprudent financial products created in a world of unlimited leverage - for example 100 per cent mortgages - would disappear. And tougher lending conditions would, in turn, push down those asset prices most dependent on leverage, especially housing.

In short, the real economy would weaken but not to the disastrous extent apparently implied by the scale of the financial crisis. This seems a reasonable description of conditions in the world economy since the credit crunch started – and they will probably continue at least until the end of this year.”

As Kaletsky noted, US and European bank balance sheets have been “squeezed like a concertina” with a collective \$US532 billion of mortgage related write downs having already taken place.

And while remaining solvent has taken on new importance, banks of all persuasions have struggled to attract the necessary capital to replace that which has been lost.

The rump of the problem, apart from actually writing lots of dodgy loans, stems from the mechanics of funding these questionable loans. In short, there has been a funding mismatch. In their haste to grow, banks have chosen to load up on long duration assets (mortgages) financed by cheaper, short term debt instruments.

The gig is now up and in their scramble to meet their debt obligations, an almighty rush to secure new lines of credit has had the dire consequences the financial world now finds itself in. Never mind that in probably many instances, monthly mortgage repayments continue to be made by borrowers.

This is where the opportunity is largest. Those that are now in the box seat to buy these distressed assets, at fire sale prices are likely to recoup their capital plus benefit from the eventual restoration of confidence in the financial banking system.

As for investors, if the truth be known, banks simply underestimated that mortgage loans could go bad and in doing so, they have benefited over the years by reporting higher profits than should have been the case. In many ways, the growing pile of losses is just

reversing profits that, in reality, were never earned.

And it's clear to us that from here on only the fittest will survive. Already the run on banks has led to a wave of shotgun mergers that will reshape the industry almost overnight. Consolidation among the large and smaller players will dominate the headlines for some time. Suffice to say that the next breed of winners will emerge from the ashes of those that have fallen. *SFM*

Confidence, ratings and neuroeconomics.

Neuroeconomists use MRI scanners and psychological tests to try to overturn traditional economic theory that assumes people act rationally when it comes to financial decisions.

“confidence is the way Wall Street spells God”

And at the core of today's problems are securities that were backed by risky mortgages. The theory was that slicing and dicing mortgages would dilute the risk.

The fact that ratings agencies were being compensated by the issuers of mortgage backed securities (MBS) created the problem according to George Lowenstein, of Carnegie Mellon University. *“You don't get mistakes this big based on stupidity alone. It's when you combine stupidity with people's incentives that you get errors of this magnitude”.*

This all started more than four years ago when the world's two largest bond analysts and ratings providers eased their standards at the request of clients.

In August 2004, Moody's Investors Services unveiled a new credit rating model. And a week later Standard & Poors (S&P) revised its own methods. Apparently its only other choice was to lose business to Moody's.

Between 2002 and 2007, Wall Street underwrote US\$3.2 trillion of loans from homebuyers with bad credit and undocumented incomes. Much of the debt was then packaged into investment pools that were awarded AAA ratings, the gold standard, by Moody's and S&P.

It turns out that S&P and Moody's earned up to three times more for rating complex unregulated investment pools such as collateralised debt obligations (CDO's) than from corporate bonds.

By August 2008, Moody's had downgraded 90% of all asset backed CDO's issued in 2006 and 2007 including 76% of all AAA rated paper.

Moody's analyst Sylvain Raynes commented, *"If you lose that confidence, you lose everything, because that confidence is the way Wall Street spells God"*.

Gregory Berns, a neuroeconomist from Emory University said *"Fear plus herding equals panic. It's biologically based"*. **SFM**

NAB, can you handle the truth

In our December 2007 quarterly cover article titled "Can You Handle the Truth" we highlighted the growing tendency of company executives to spin facts and omit information, often to the detriment of ordinary shareholders.

A case in point was National Australia Bank's update titled "NAB Conduit Risk Mitigation" released to the Australian Stock Exchange on 30 September 2008. We have reprinted the announcement below and have added our own take.

The timing of the release and its spin on the truth simply lack integrity. While some may argue that all the facts are present, shareholders are left to put all the pieces together and frankly they deserve a whole lot better. **SFM**

Dow Jones tanks 7%
ASX tanks 4.3%
NAB makes announcement at 5.54pm when most people are heading home for the day

Tuesday, 30 September 2008

NAB Conduit Risk Mitigation Announcement

National Australia Bank (NAB) today announced it has completed **a risk mitigation strategy in relation to the \$1.6 billion of Synthetic CDOs (SCDOs) within its conduit portfolio.**

Enlightening – but means nothing to us

In particular:

Your'e kidding, are there any left?

A substantial amount of work has been undertaken to mitigate the risks associated with the SCDOs. As a result of this work long-dated hedges have been entered into with a **large, highly reputable, global bank counterparty**, which strengthen NAB's position and substantially reduce the likelihood of loss arising from the SCDOs. The new protection levels mean that the SCDOs would be able to withstand corporate default **rates equivalent to the worst of those experienced over the past 90 years.**

Irrelevant in the context of events this year

You just paid a huge price to hedge the loss

All conduit assets have been reviewed and as of today **no further material provisioning** against this portfolio will be reflected in NAB's 2008 results. All conduit assets will remain subject to normal credit review processes until maturity. NAB's **external auditor Ernst & Young has had oversight of the provision** treatment announced today and confirms this outcome.

Thank god the auditors signed off on this

The accounting impact of the hedging and related actions taken to reduce conduit asset risk will **lower 2008 cash earnings by approximately \$100 million.**

Some truth comes out

On-going hedge costs will approximate \$60 million in cash earnings per annum for the next five years and a lesser amount thereafter. These costs will be accommodated within normal levels of credit hedge spending and therefore will not affect 2009 cash earnings.

And yes the pain is spread out over many years so it doesn't seem so bad right now

COMPANIES VISITED DURING THE 1st QUARTER 2008-2009

July

IRE	Iress Market Technology	01/07/08
PXS	Pharmaxis quarterly conference briefing	24/07/08

August

RMD	Resmed FY results	06/08/08
PBT	Prana Biotechnology management meeting	06/08/08
WBC	Westpac Banking management briefing	08/08/08
SGB	St George Bank management briefing	12/08/08
COH	Cochlear full year results briefing	12/08/08
TLS	Telstra full year results briefing	13/08/08
ASX	ASX full year results briefing	14/08/08
SAI	SAI Global full year results briefing	15/08/08
SEK	SEEK full year results briefing	18/08/08
IRE	Iress full year results briefing	19/08/08
IFM	Infomedia full year results briefing	20/08/08
PPT	Perpetual full year results briefing	20/08/08
CAB	Cabcharge full year results briefing	21/08/08
QBE	QBE Insurance half year results	21/08/08
BNB	Babcock & Brown full year results briefing	21/08/08
BBG	Billabong full year results briefing	22/08/08
PRY	Primary Health Care full year results briefing	26/08/08
FLT	Flight Centre full year results briefing	26/08/08
FLX	Flexigroup full year results briefing	26/08/08
WPL	Woodside Petroleum half year results briefing	27/08/08
AUW	Australian Wealth Management full year results briefing	27/08/08
TTS	Tatts Group full year results briefing	28/08/08
ALL	Aristocrat Leisure half year results briefing	28/08/08
ROC	ROC Oil half year results briefing	29/08/08
NHF	NIB full year results briefing	29/08/08

September

SEK	SEEK conference call	18/09/08
MQG	Macquarie Bank management briefing	22/09/08
SIP	Sigma half year results briefing	22/09/08
ASX	ASX annual general meeting	24/09/08
N/A	Donaldson IPO	26/09/08
GGY	Glengarry management meeting	30/09/08