

## FUND PERFORMANCE

Since inception in December 2004 the Fund has delivered a compound annual return of 26.9% to 31 December 2007 (inclusive of \$0.0709 cents in distributions), outperforming the All Ordinaries Accumulation Index, which has compounded at 22.8% over the same period. Statistics page 15 *SFM*

## BIG PICTURE

### Can You Handle the Truth?

**Jessep:** You want answers?

**Kaffee:** I think I'm entitled to them.

**Jessep:** You want answers?

**Kaffee:** I WANT THE TRUTH!

**Jessep:** YOU CAN'T HANDLE THE TRUTH!

Son, we live in a world that has walls. And those walls have to be guarded by men with guns. Who's gonna do it?

You? You, Lieutenant Weinberg?

I have a greater responsibility than you can possibly fathom. You weep for Santiago and you curse the Marines. You have that luxury. You have the luxury of not knowing what I know: that Santiago's death, while tragic, probably saved lives. And my existence, while grotesque and incomprehensible to you, saves lives...You don't want the truth. Because deep down, in places you don't talk about at parties, you want me on that wall. You need me on that wall.

We use words like honour, code, loyalty...we use these words as the backbone to a life spent defending something. You use 'em as a punch line. I have neither the time nor the inclination to explain myself to a man who rises and sleeps under the

blanket of the very freedom I provide, then questions the manner in which I provide it! I'd rather you just said thank you and went on your way. Otherwise, I suggest you pick up a weapon and stand a post. Either way, I don't give a damn what you think you're entitled to!

**Kaffee:** Did you order the code red?

**Jessep:** I did the job you sent me to do.

**Kaffee:** Did you order the code red?

**Jessep:** YOU'RE GODDAMN RIGHT I DID!

Legendary Hollywood actor Jack Nicholson starred in the 1992 drama filled classic, "A Few Good Men" and almost walked away with an Oscar.

In that famous courtroom scene recounted above, tough marine officer Colonel Nathan R Jessup (Jack Nicholson) took the stand to be cross-examined.

Representing the Navy is upstart lawyer Lieutenant Daniel Kaffee (Tom Cruise). He leaves no stone unturned in uncovering the truth about a "code red" ordered by Jessup that goes horribly wrong, resulting in the death of a fellow marine.

***"Investors seem to start from the premise that they are entitled to immunity from losses"***

While Jessup is a tough nut to crack, ultimately even he can't escape the truth, exploding with "YOU CAN'T HANDLE THE TRUTH!"

That Jessup comes across as a great commander and leader of men is under no dispute. When pressured he exudes confidence while his style is hard nosed and no nonsense. In executing orders Jessup uses whatever means available to get the job done with a genuine belief that the team is more

important than the individual. No doubt, these are all good leadership qualities.

However in this instance, ordering a “code red” was justified as being in the best interests of the platoon - protecting the lives of others that Private First Class Santiago had endangered by failing in the line of duty.

We were particularly interested in the courtroom tactics used by Jessup. And the reason for our interest is that we are increasingly seeing these tactics applied in boardrooms around Australia.

While it’s not fair to compare the boardroom with the battlefield, it is fair to say that confronting an angry crowd of shareholders with an unpleasant truth, no matter how minor, is never an easy task. Particularly when you consider that many investors seem to start with the premise that they are entitled to immunity from losses. This of course is not reality.

***“Jessup’s first tactic ...  
omitting contentious  
statements”***

And in an era characterised by investor led class actions, ASIC led action and public prosecution by the press, shareholders have in many ways only themselves to blame.

While we believe this gives no justification for companies or individuals to engage in spin or omissions, at the very least it’s easy to understand why Jessup style tactics might be considered, modified or applied by senior executives.

Here we summarise Jessup’s courtroom tactics.

**Jessup’s first tactic;** Drive the company (Marines) line, carefully omitting any contentious statements.

**Jessup’s second tactic;** Omit the facts that directly

reveal the truth.

**Jessup’s third tactic;** Bedazzle the audience with a long-winded diatribe, preferably from the heart. This must contain truths, personal commitment, and intimations of successful outcomes but does not require any direct relevance to the issue at hand.

**Jessup’s fourth tactic;** Use alternate facts that create a diversion.

If Jessup was a guest lecturer at the Australian Institute of Company Directors (AICD) he might postulate that there are two classes of investors.

On one hand there is the traditional shareholder who passively attends meetings without ever uttering a single word. On the other hand, are the momentum players - the hedge fund / institutional investor-trader types who jump ship at even the slightest hint of negative news.

As an AICD guest lecturer Jessup would explain that if his two assumptions above hold true, then his four courtroom tactics could be applied to many awkward public disclosures. The effect is to play with and massage the facts rather than to actually present the truth. The overall outcome is of course strengthened if the company retains good legal council to sanction and support its actions as being in the best interests of the business.

If pushed, Jessup would likely acknowledge there is of course an exception to every rule - a third type of investor that is thankfully, a minority.

Readers familiar with our “Roadmap” would recall that our first consideration when analysing any business is whether we can trust management. We freely admit that this is a highly subjective matter but without an appropriate tick we won’t go any further. Furthermore we actively communicate our message to management – be upfront, tell shareholders the good and the bad and work for the common good of all owners, not just the few with

the loudest voices or vested interests.

Sometimes you just have to wonder whether there are a whole cast of company directors and management teams rooting for Jessup.

We on the other hand are left wondering why it's so hard for managers to tell the truth, particularly when all around, everyone knows what the truth really is. Well nearly everyone ... and maybe that's the point.

This quarter we highlight three examples of interesting corporate tactics, some Jessup like, that have come to our attention.

We recently attended the SAI Global AGM. On slide 20 of 42 we noted the one liner relating to earnings outlook - *"In total we are running behind forecasts"*.

There was no genuine attempt to provide clarity on the numbers, no details or comparisons were given and hence no questions were raised from the floor! Oh ... other than, one on breast cancer. And, one on climate change. Remember this is a Standards and Compliance services business.

Jessup's first shareholder assumption certainly held true here. In fact uninformed SAI shareholders clapped as the stock dropped more than 10% with its opening trade. We endeavoured to address this issue with management in a subsequent one on one meeting.

*(Disclosure: Selector does not hold AGL Energy or Commander Communications)*

Not to be outdone, AGL Energy demonstrated that Colonel Jessup's tactics can even be applied to the big end of town. On 15 October 2007 AGL Energy released an earnings guidance revision.

*"AGL's previous guidance to the market anticipated underlying net profit after tax for 2008*

*in the region of \$380 million to \$400 million. Recent market conditions, including retail energy margins, the strengthening of the Australian dollar against the US dollar and increased wholesale gas costs mean that AGL now anticipates the earnings outlook will be in the region of \$330 million and \$360 million."*

***"It's a surprise to me. I'm absolutely as surprised as you are surprised"***

Obviously everything was just fine on 10 September 2007 when CEO Paul Anthony presented to institutional investors in North America. He confirmed the company was on track to meet the group's stated 15% increase in profit and reiterated the guidance.

Whatever happened in that intervening five-week period, wiping some \$40m off the group's bottom line remains a mystery. When answering analysts questions about the apparent mismatch Mr Anthony admitted as much.

*"It's a surprise to me."*

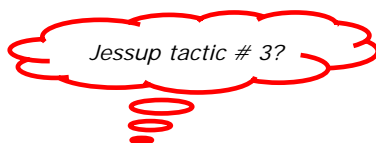
Apparently he only became aware of the shortfall when reviewing the September accounts.

*"I'm absolutely as surprised as you are surprised. These are very recent movements"*.

Fair enough, sometimes things go wrong.

Was it human error in interpreting financial data that finally came to light, or perhaps a management team that was so hell bent on hitting targets that it actually forgot to check whether the targets were even achievable? Who would know? Perhaps the Chairman could help explain the change in circumstances. Fortunately we were in luck, with AGL releasing an update on 22 October 2007.

But what's this, Michael Fraser, a long time group senior executive was taking over as CEO.



***“Having achieved much of what he was asked to do by the Board, it was an appropriate time for a change in management”***

Following Mr Anthony's cessation of employment, AGL Chairman Mark Johnson said.

*“Michael Fraser's appointment reflects the Board's view that the company would benefit from a new management approach to complete the execution of our strategy to build AGL into a world class integrated energy company”.*

*“Mr Anthony agreed that having achieved much of what he was asked to do by the Board, it was an appropriate time for a change in management.”*

Great! So it looks like everyone's in agreement.

Despite being in the job less than eighteen months and the fact that Fraser represents AGL's fourth CEO in less than two years, we're asked to believe that everything is on track and reflecting the company's careful execution of becoming “a world class integrated energy company.”

Was this an application of tactics # 1, 2 and 3?

As outsiders looking in we are certainly none the wiser as to what happened in that “surprising” five-week period. We imagine a few shareholders are scratching their heads ... then again maybe not, if shareholder assumption 1 holds true.

Finally on 8 January 2008 we read with interest the Sydney Morning Herald (SMH) article that noted that after three swift profit downgrades

*“The shake up at Commander Communications had claimed the scalp of two directors, just weeks after three senior managers were forced out”.*

The two directors referred to in the SMH are Bill Scales, a former head of regulatory affairs at Telstra and Neil McDermott, ex chairman of Integral Energy.

*“Commander's recently appointed Chief Executive, Amanda Lacaze, declined to reveal whether the directors had left because of recent problems. She insisted Mr McDermott was leaving because of other commitments, including a need to take more travel”.*

OK ... that makes sense to us. A job does sometimes get in the way of travel!

Which tactic is applied here? You guessed it! Tactic # 4!

Let's be very clear here, investors entrust management and boards to deal with company matters. In this arrangement shareholders truly are outsiders despite being the rightful owners. They are told only certain matters and kept in the dark for the vast majority of the time. And while this is a function of how the capitalist system works, what is inexcusable is the level of spin and omission that is now so much part of the way those who manage communicate to those who own.

Shareholders deserve better no matter how big their wallet is. This is exactly the type of behaviour from a management team we are seeking to avoid.

And while we are initially making a judgement call on individuals, we think focusing on “truth” as one of our key benchmarks is a great measure. Eventually you always get it from a business.

Sooner or later both the milestones and the financials deliver the truth. Not even Jessup like tactics can prevent that.

So the key skill here is to find out the truth about a business and its managers sooner rather than later. Generally this discovery process requires time and is a function of both business complexity and transparency.

It follows then that by using our “Roadmap” we clearly seek to invest in businesses that have a “simple structure”. Dick McIlwain CEO of the Tatts Group refers to them as businesses with “few moving parts”. Warren Buffett says only invest if you understand. Whichever way you cut it, “complexity”, “transparency” and “simplicity” have taken on extra importance in the market this quarter. And if you have invested in businesses that have complexity and debt you most likely have experienced a rapid de-rating. *SFM*

**2007 the year of living dangerously**

Are we the only manager who questions the spin and omission so commonly used in the market?

***“Any number of bandits and thieves come into the boardroom with intent to relieve us of client funds”.***

Last August Tony attended an investment seminar featuring a number of well-regarded fund managers. One in particular was David Paradise. Recounting his many company meetings, he noted “Any number of bandits and thieves come into the boardroom with intent - to relieve us of client funds”.

So 2007 could be described as the year of living dangerously or at least with bandits in our midst. Early in the piece, risk was ignored and spin was rewarded. The year started with a buzz of activity

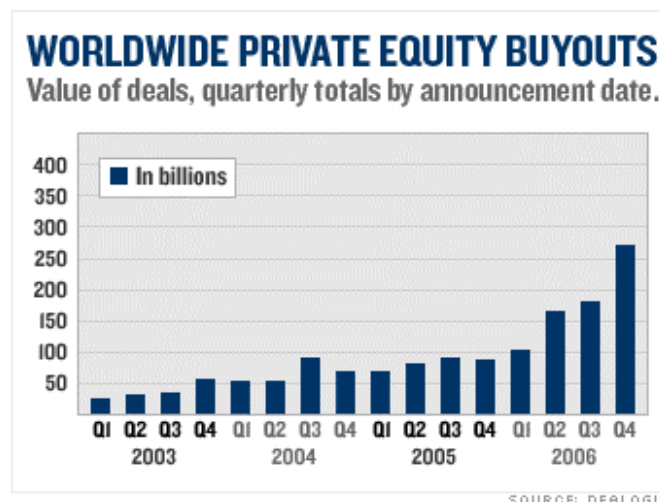
led largely by private equity. But by mid year it started to unwind. In our June 2007 quarterly we penned “sub-prime explained ... somewhat” as the first cracks appeared in the US housing sector.

The following pictorial and diagrams provide a brief overview of 2007.



Free and easy credit policies globally provided bags of liquidity and by the end of 2006 private equity deal flow was already running hot. The 2007 year kicked into gear at full speed. Allan Moss, CEO of Macquarie Bank, commented that global liquidity was the strongest he had seen by a magnitude.

At one point it was thought no company was too big to be acquired and restructured. Lazy balance sheets were condemned.

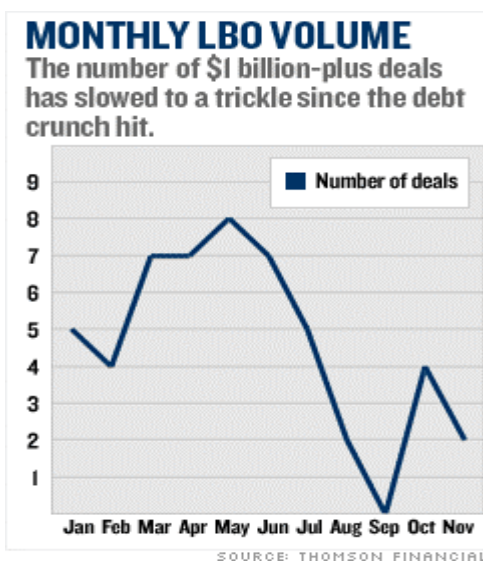


By mid 2007 conditions took a turn for the worse, particularly in the US where the credit crunch virtually put a stop to global liquidity supply. These events coincided with and rattled a slowing US

economy. Domestically the first signs of tougher local conditions emerged with both inflation and interest rates on the rise.

Financially complex businesses were sold off. Those carrying truck loads of debt were savaged. Downgraded results were smashed. And many others were put into the “sin bin”, sold off just for good measure.

Consequently many leveraged buyouts failed to complete and the pipeline slowed. As always the US markets led both the charge and retreat as “risk consideration” came into clear focus. The truth is that the high returns and benign conditions experienced in the past three years are unlikely to be replicated any time soon.



Unfortunately we don't know what's around the corner either. Though like others, we can offer our best guess (see 2008 outlook). That's the truth, and interestingly it is exactly the same view we held when we established this business more than 4 years ago. **SFM**



**2008 outlook - Our Best Guess**

The good news is that long-term investment in a concentrated portfolio based on bottom up stock selection is well suited to the prevailing investment climate. Big Statement? Perhaps, but tiptoeing your way through the 2008's mine field of corporate downgrades will require greater skill and less luck than previous periods.

Back home, growth in Australia will slow in 2008 but we expect it to stay above the long term trend rate. Low to mid 3% is a reasonable guess. Last year the Australian economy expanded by 3.9% (2.8% in 2006), as full employment, high private consumption, increased household wealth, and tax cuts provided a turbo boost to the economy.

As a result, it is highly likely that the Reserve Bank will be forced to increase official cash rates in Feb 2008 as inflation threatens to stay above the 2-3% tolerance level. We guess the Australian dollar will likely continue upward at a more moderate clip.

For equities it will be challenging. While the market average price to earnings ratio of 15x (*pre Jan 2008 sell off*) is not overly stretched, applying simple ratios such as these can hide many sins. Broker JP Morgan forecast earnings growth of 12% –13% in the current year, with a likely decline to

the high single digits by 2009.

Furthermore their research highlights that volatility has shifted up a gear or two. In fact market volatility (measuring the move away from the mean or average for the ASX 200 Index) is now 17% per annum compared to 10% a year ago and a five-year average of 11%. We expect volatility to remain high in 2008.

As investors shift their attention from 2008 to 2009 the declining earnings profile coupled with high market volatility will require an even greater focus on fundamental company analysis and bottom up stock selection. From our vantage point, 2008 will more than ever, require us to remain vigilant by saying “no” to a lot of investments but more on that later.

The key threat as we see it is unexpectedly weak growth in the global economy. And at this point the threat sits with developed economies. The headwinds from the US housing debacle, tighter credit conditions and higher energy prices will have their greatest impact in the US, Canadian, UK and European markets, all of which have been hardest hit by the tightening liquidity supply. *SFM*

*\* Figures from JP Morgan and The Economist*

### **Avoiding landmines in 2008**

So it should be no surprise that we think 2008 is all about avoiding the landmines from both a macro perspective and at the all important stock selection level. Success here will go a long way towards the goal of capital protection. Since this is a strong focus of ours it's worthy of a comment.

***“Simply put, the cash flow statement was a train wreck”***

The past two quarters have given investors a solid reminder of the impact of downgrade driven landmines. Dyno Nobel, and the Centro Group are

just two recent examples, with the latter having market wide ramifications in the lead up to Christmas.

Avoiding a landmine involves a process of saying “no” to a lot of investment opportunities. And looking at a business and saying “no” really does consume a lot of our time. And it's important to consider the implications of this in relation to our performance. Last financial year some of our peers shot the lights out with +40% returns, however the risk they were taking was unacceptable to us.

***“...these guys where serious Jessup style directors”.***

A great example in 2007 was Blue Chip Financial Solutions (BCF). Yes, we too thought the name was dodgy. A client asked us to have a look. So we did some reading, attended the AGM and set a date to meet management. The BCF share register was the who's who of investors including Macquarie Bank, CVC and some leading fund managers.

Simply put, the cash flow statement was a train wreck. The founder of BCF, although a financial sponsor of kiwi rugby, was not well regarded in New Zealand. BCF cancelled and rescheduled no less than four meetings, one when we were standing at the reception desk. At the AGM presentation a cash flow statement was mysteriously absent. The final straw was the chairman's address in the annual report. It triumphantly declared the dividend might be issued as shares rather than cash, in a shareholder friendly initiative. Truth or spin?

To make matters worse the principal was selling into a record stock price often to institutional investors. You would have thought these guys were serious “Jessup style directors”.

But the real surprise for us was the CEO's preparedness to be open and candid. Wide eyed and

looking a bit “shell shocked”, he gave us a warts and all account including the “black hole” responsible for the missing cash flow. Nothing was hidden from us.

We still can’t understand how professionals got caught in this one, particularly with such an open and honest CEO highlighting the cash flow perils.

The point we make here is that we have not chased returns in a strong market, something that we believe has held us in good stead as we end 2007 and enter the new year with capital protection and risk aversion top of mind. *SFM*

*\* Figures from JP Morgan and The Economist*

**Valley of death**

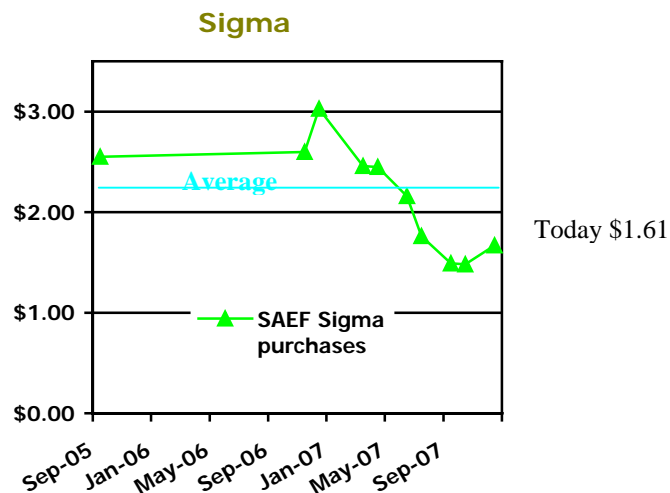
So if we dodge landmines why are we prepared to enter positions or hold stocks when the prevailing sentiment suggests otherwise.

In fact we have noted in previous newsletters that often our best investments give us the biggest bumps and bruises along the way. Aren’t these landmines of sorts? The truthful answer is yes. But we call it riding through the “valley of death”. The second horrible truth is that we don’t always get our timing right.

Here we examine two “valley of death” experiences. In the first example we are currently experiencing the chilly winds of the valley. In the second we have emerged in the greener pastures and warm glow of a friendly stock market.

It never ceases to amaze us how far the pendulum can swing from over sold to over valued. The first is the opportunity, the latter more of a waiting game as company fundamentals try to catch up and surpass the valuation of the day. Generally speaking, great investors have often distinguished themselves through one or two long held winning positions. That often means experiencing both ends of the spectrum including the “valley of death”.

We were in Melbourne in November 2007 to meet the Chairman, CEO and non-executive directors of drugs group Sigma Pharmaceuticals. That’s right not just the CEO but the Chairman and a number of non executive directors were present. It’s amazing how forthcoming and open companies become when they are friendless.



Sigma is a stock that has wrong footed us to date. It’s pretty safe to say it is going through the “valley of death” right now. In late December it even appeared as one of Citi’s top sell ideas for the week. Not surprisingly, Citi considered Sigma a buy at \$2.40 prior to the two downgrades. (Citi is Citigroup’s new name. In general we question companies that change names!)

A key comfort for us during this period has been the strong balance sheet with 16% debt to equity and 6x interest cover before the buyback. Sigma’s gearing after the recently completed 10% buyback sat at 25%.

And here the company got lucky. Having initiated the buyback at a price of \$2.20 the intervening downgrades have seen the purchase and cancellation of 94 million shares at an average price of \$1.65 per share.



Few companies get the opportunity to buy back shares at 52-week lows. As we pointed out this was luck more than management skill. That said, they bought when most brokers were posting sell recommendations

During our visit Sigma's Chairman Dr John Stocker (also Telstra's longest serving director - a great contact) was very open about the need for transparency in order to restore shareholder support. The Directors are genuinely concerned about the problems the have beset the business. Yet there is no finger pointing or moves to sack the CEO in an attempt to distance past errors.

In fact from the CEO up there is an acceptance that mistakes have been made in 2007. We see this as an important stage on the roadmap. And we believe that it is entirely likely that perception will remain tarnished longer than the business fundamentals and herein lies the opportunity.

Sigma had troubles on three fronts in 2007.

1. Community Service Obligation (CSO)
2. Embrace Program
3. Generics

Collectively these issues impacted the business and resulted in profit down grades. Individually none of them were company breakers.

What is most important is that management clearly identified the issues at hand and that the CEO was candid enough in admitting mistakes were made in relation to both the earnings expected from the CSO and the implementation of the Embrace Program.

Originally the \$150 million per annum CSO payment (*based on market share and paid to pharmaceutical wholesale providers who met their community service obligation of delivering drugs nationally to pharmacists as set down by the Fourth*

*Pharmacy Guild Agreement*) was expected to be divided between the three traditional wholesalers but a fourth party, logistics provider DHL, entered the fray. Having originally underestimated their presence it now appears Sigma's CEO Elmo de Alwis's stance had some merit with DHL recently choosing to become non-compliant, thereby losing future payment rights from the fund. And with cost of delivery being such a key component the industry has sensibly moved to once daily deliveries to pharmacists who previously received two deliveries per day if required.

Secondly, Sigma's full service offering to pharmacists titled "Embrace", failed to get the necessary compliance expected. In many ways it sounded great on paper but was badly executed in practice. That said we believe the program has considerable merit and Sigma management, having identified those pharmacies that are non compliant, is now working diligently to address the issues. In short, Sigma aims to provide a complete offering, including bigger discounts to those that comply and in return Sigma should benefit from growing market share and higher margins.

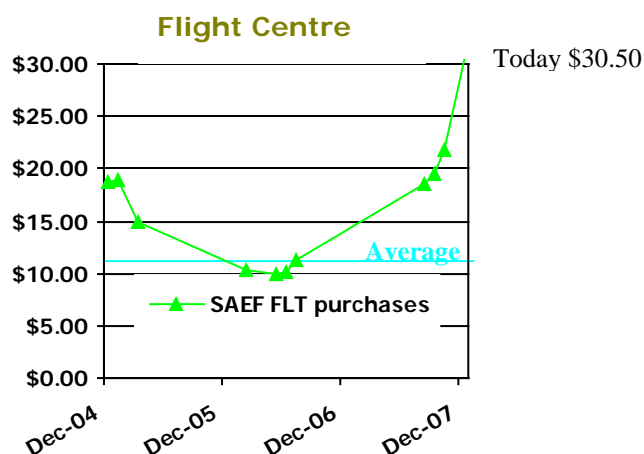
Finally Sigma's generic drugs business (selling the bioequivalent of drugs no longer on patent) turns over gross revenues of \$450M. A new entrant in the Australian generics space – Indian generics supplier Ranbaxy – attempted to grab market share. This forced Sigma to offer an additional discount of 5% across its entire generics range that effectively wiped \$22 million off the current year's gross profit (*Sigma have a January year end balance date*).

To date Ranbaxy have failed to gain any significant market share with 2008 likely to be a telling year. Pharmacists have not supported Ranbaxy and are starting to understand that discounting is a negative for the industry as it will lower overall margins under the Government's new PBS initiative to take effect in August 2008.

For our part we came away from our November 2007 meeting with the belief that.

1. Issues have been identified
2. Issues are being addressed
3. Business fundamentals remain intact
4. Current valuation provides opportunity

We expect these issues to be addressed during the course of the 2008, while initially all eyes will be on the group’s full year profit guidance of \$88 - \$93 million.



In the second half of 2007 Flight Centre (FLT) emerged from the “valley of death”. But it’s not so long ago that top rated Flight Centre analyst Charlie Green slapped a sell on the stock with a target in the \$7- \$8 range. In fact they did trade sub \$9 so Charlie was vindicated for a little while.

Flight Centre is an example of a stock that has given us significant bumps and bruises but has also achieved milestones. The key to Flight Centre’s woes were issues that were largely identified by management and could be rectified by management. The management team was prepared to make some tough decisions in the short term for longer term gains.

Two failed privatisation attempts and the reasons put forward by management certainly had us question their motives. That said, we drew

sufficient comfort that this was a business and management team worth backing, operating a business model that was far from broken. A point not lost on the private equity team left positively salivating at the chance of owning a business that was neither out-dated or ex growth. Both management and private equity recognised the “valley of death” as an opportunity. Fortunately so did we. *SFM*

**Holiday reflections**

Anyone with a three year old knows that holidays are better spent at home unless you take grandparents. We learnt this lesson a year ago with a certain two year old that has previously featured in this newsletter.

So this year we planned an open ended stay at a beach house three hours drive from Sydney. We had a double bed, Dad and son. But we both slept on the same side.

The little fellow slept soundly and bounced out of bed at 5am. Dad must have woken very briefly between 5 and 10 times during the night. This is an exercise you can try at home with an alarm clock! The impact on the body the following day is remarkable. Broken sleep is absolutely debilitating.

If you happen to suffer from Obstructive Sleep Apnoea (OSA) you can be woken up to 40 times a night when you gasp for air, as your upper airway collapses the brain is starved of oxygen and consequently jolts the body out of the sleep cycle.

In terms of the “valley of death” illustrations of Sigma and Flight Centre, one could place ResMed somewhere in the middle.

ResMed is a company that has a compelling product offering that treats OSA and now complex OSA in an industry that is undergoing a very positive structural shift. We believe it is an industry that is blossoming and the mid 2007 share price

low point provided a rare opportunity in ResMed.

ResMed caused us pain early in 2007 with a \$US60 million voluntary product recall. This was compounded by a market obsessively focused on incremental margin gain even though some margin slippage was to be expected.

It was at this point that we were encouraged by a client to gain an understanding of a competing technology which we had previously dismissed. This was a valuable exercise but it left us in no doubt about the strength of ResMed's product range and market position. As for the competing technology we had concerns about its corporate structure, business scalability, funding and management. In terms of valuation it was cheap but that alone is not enough for us to consider it for longer term ownership.

In late 2007, the key US market took a giant leap forward with the Government advisory panel proposing wide ranging reforms to approve in-home diagnosis of obstructive sleep apnoea. Many have labelled these reforms a "paradigm shift" that will likely see awareness and industry demand grow to new levels. As these events were unfolding, ResMed's chief competitor Respironics was in the final stages of accepting a \$US5.1 billion cash offer from Dutch giant Royal Philips Electronics.

This will be an interesting space to watch and participate in over the next few years. *SFM*

### **A New Dawn**

A chillingly common experience when you enter the "valley of death" is how the "P" (the price) of a stock adjusts so quickly and dramatically (usually down) to reflect the pressure on the "E" (the earnings).

In the case of Flight Centre, a tough few years on the earnings front and rising concerns regarding its

business model sowed enough seeds of doubt resulting in a stock price slump to ten year lows of \$8.95 in October 2005. Since then it has been all one way traffic, with a soaring profit line catapulting the stock into record territory at circa \$32.00.

In the case of Sigma, we still await our fate. If our sense of management and the business is correct then the current share price may well turn out to be a bargain a few years down the track.

However there is the flip side to the use of P/E ratios as a guiding light. As we enter the new calendar year it is becoming quite apparent that the popular press are reporting a new era for the Australian share market. For it seems our market, as measured by the All Ordinaries Index, has entered its own minefield. Market observers note that since hitting record highs of 6,854 on 1 November 2007, the index has fallen greater than ten per cent, giving rise to a popular term "technical correction".

We have no idea of what relevance this term has in relation to picking great businesses but we suggest the real news is tucked deep in the mid sections of financial newspapers. Here we're talking about the columns of stocks hitting 52 week highs and lows.

And not surprisingly a falling market has given way to a number of higher quality businesses hitting fresh lows including Billabong, Fisher & Paykel Appliances, Henderson Group, Lend Lease, National Australia Bank, Perpetual, St George Bank, Soul Pattinson, Suncorp-Metway and Tabcorp, to name a few.

For the most part these falls are not only necessary but are welcome. News of "technical corrections" will no doubt cause some investors to panic and throw out the good with the bad.

The real skill will be in separating those that should fall from those that represent a great opportunity to

acquire a business at a much-reduced price. We look forward to such rare opportunities where skill rather than luck is rewarded. *SFM*

**And Finally**

In our September 2007 quarterly update we wrote about the impending float of health insurer NIB Holdings.

It remains early days but we decided to dip our toe and invest at what we then considered an attractive offer price of \$0.85 per share. Apart from the rapid rise in NIB’s share price, industry consolidation is now under way with the industry’s number two and three players MBF and BUPA considering joining hands. Should the MBF members agree to BUPA’s \$2.4 billion offer, they will command a similar market share to leading player Medibank.

And unfortunately any aspirations Medibank had of listing on the market evaporated with the change in Government leadership.

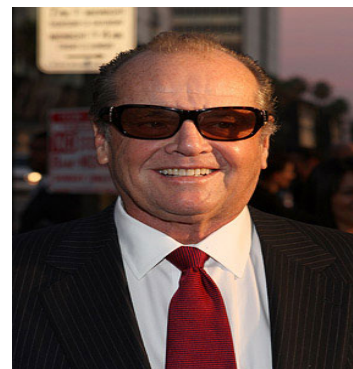
As the only listed health provider NIB certainly has the opportunity to drive further consolidation. Time will tell whether this will be a sensible long term strategy but our sense of it is that they are on the right track.

While we are onto things involving Governments, spare a thought for the NSW Premier Morris Iemma. Finally he’s got a shot doing what former Premier Bob Carr couldn’t do, (amongst others) and that is privatising the NSW power industry.

Again it is early days but already the decision to sell off the state’s electricity retailing businesses and lease its power plants for a reported \$15 billion is poised to spark a bidding war among utility companies as well as potentially offering locals an opportunity to participate.

If the past is anything to go by, Governments are

notoriously bad sellers of businesses. We will hopefully have more to say on this topic in our next quarterly update as we go on the road to interview an industry player who will undoubtedly help us understand some of the key issues facing this sector and where the ultimate opportunities may lie. *SFM*



Jack Nicholson

**Our 3<sup>rd</sup> Year Anniversary**

| <b>Best Performing Australian Equities Funds</b> |              |
|--|--------------|
| <b>3 years to Dec 2007</b>                       |              |
| Independent Asset Mgmt                           | 29.4%        |
| Northward Australian Equities                    | 28.2%        |
| Merrill Lynch High Growth                        | 27.9%        |
| ING Select Leaders                               | 27.2%        |
| <b>Selector Fund</b>                             | <b>26.5%</b> |
| BT Institutional Imputation                      | 26.3%        |
| Merrill Lynch High Conviction                    | 25.6%        |
| Contango Australian Equities                     | 25.4%        |
| Perennial Growth Aust Shares                     | 25.2%        |
| Hyperion Aust Growth                             | 24.8%        |
| ABN Amro Aust Equity                             | 24.7%        |

This table appeared in the Australian Financial Review on 15 January 2007. We have focused on the 3 - year return and note that we did not achieve the 1-year return top 10. We have taken the liberty of adding the Selector Fund 3 - year return of 26.5% for comparative purposes, as we were not included in the ANZ RBA ABS figures quoted as the source of the table. Like all lists they are often not exhaustive *SFM*

## COMPANIES VISITED DURING THE 2nd QUARTER 2007-2008

### October

|     |  |          |
|-----|--|----------|
| SAI | SAI Global management meeting                                      | 8/10/07  |
| PXS | Pharmaxis site visit   | 12/10/07 |
| ACL | Alchemia life science conference                                   | 15/10/07 |
| SHC | Sunshine Heart life science conference                             | 15/10/07 |
| CXS | Chemgenex Pharmaceuticals life science conference                  | 15/10/07 |
| UBI | Universal Biosensors life science conference                       | 15/10/07 |
| NAN | Nanosonics life science conference                                 | 15/10/07 |
| BTA | Biota life science conference                                      | 15/10/07 |
| AVX | Avexa life science conference                                      | 15/10/07 |
| HXL | Hexima life science conference                                     | 15/10/07 |
| CXD | CathRx life science conference                                     | 15/10/07 |
| PXS | Pharmaxis life science conference                                  | 15/10/07 |
| ACR | Acrux life science conference                                      | 15/10/07 |
| COH | Cochlear life science conference                                   | 15/10/07 |
| FLT | Flight Centre conference   | 17/10/07 |
| WEB | Webjet conference  | 17/10/07 |
| MFS | MFS conference   | 17/10/07 |
| TSE | Transfield Services conference                                     | 17/10/07 |
| HFA | HFA Holdings conference  | 17/10/07 |
| EBB | Everest Babcock & Brown conference                                 | 17/10/07 |
| AUW | Australian Wealth Management conference                            | 17/10/07 |
| CUS | Customers conference   | 17/10/07 |
| JBH | JB Hi-Fi conference  | 18/10/07 |
| CIF | Challenger Infrastructure Fund conference                          | 18/10/07 |
| PRG | Programme Maintenance conference                                   | 18/10/07 |
| KBC | Keybridge Capital (formerly Mariner Bridge Investments) conference | 18/10/07 |
| MLE | Macquarie Leisure conference                                       | 18/10/07 |
| TPI | Transpacific conference  | 18/10/07 |
| BOL | Boom Logistics conference  | 18/10/07 |
| NWH | NRW Holdings conference  | 18/10/07 |
| PMC | Platinum Capital AGM   | 19/10/07 |
| SRX | Sirtex AGM   | 23/10/07 |
| NHF | NIB Holdings IPO Briefing  | 23/10/07 |
| COH | Cochlear AGM   | 23/10/07 |
| GLB | Globe AGM  | 24/10/07 |
| PXS | Pharmaxis quarterly conference call                                | 26/10/07 |
| SAI | SAI Global AGM   | 26/10/07 |
| ASX | ASX AGM  | 30/10/07 |
| TLS | Telstra open day   | 31/10/07 |

### November

|     |  |          |
|-----|--|----------|
| COH | Cochlear conference  | 1/11/07  |
| RMD | Resmed conference  | 2/11/07  |
| VGH | Vision Group conference  | 2/11/07  |
| API | Australian Pharmaceutical Industries conference                    | 2/11/07  |
| GAA | Genepharma conference  | 2/11/07  |
| SIP | Sigma conference   | 2/11/07  |
| PXS | Pharmaxis AGM  | 5/11/07  |
| SAI | SAI Global site visit  | 6/11/07  |
| TLS | Telstra AGM  | 7/11/07  |
| CCP | Credit Corp conference call  | 8/11/07  |
| PRY | Primary Healthcare conference call                                 | 8/11/07  |
| KYC | Keycorp AGM  | 9/11/07  |
| KFM | KFM Diversified Infrastructure & Logistics Fund management meeting | 9/11/07  |
| FLT | Flight Centre briefing   | 12/11/07 |
| PAB | Patrys management presentation                                     | 12/11/07 |
| CCP | Credit Corp AGM  | 13/11/07 |
| TRG | Treasury Group AGM   | 14/11/07 |
| HHL | Hunter Hall AGM  | 20/11/07 |

**COMPANIES VISITED DURING THE 2nd QUARTER 2007-2008****November**

|     |                                      |          |
|-----|--------------------------------------|----------|
| CAB | Cabcharge AGM                        | 21/11/07 |
| RRA | RR Australia management presentation | 21/11/07 |
| SIP | Sigma site tour                      | 27/11/07 |
| FXL | Flexigroup AGM                       | 29/11/07 |
| TTS | Tatt's Group AGM                     | 29/11/07 |

**December**

|     |  |          |
|-----|--|----------|
| PXS | Pharmaxis conference                       | 4/12/07  |
| AAH | Arana Therapeutics management presentation | 5/12/07  |
| RMD | ResMed site tour                           | 7/12/07  |
| COH | Cochlear site tour                         | 7/12/07  |
| FXL | Flexigroup site tour                       | 11/12/07 |
| CCP | Credit Corp management presentation        | 21/12/07 |