

FUND PERFORMANCE

Since inception in November 2004 the Fund has delivered a compound annual return of **29.95%** to 30 June 2007 (inclusive of **\$0.0709** cents in distributions), outperforming the All Ordinaries Accumulation Index, which has compounded at 25.99% over the same period. The one-year return to 30 June 2007 was **21.57%**. Statistics page 13. *SFM*

BIG PICTURE

"From the heart"

Books are great, that's why this quarter we are sending you one - our clients (not other readers).

An autographed copy of Will Hutton's *The Writing on the Wall - CHINA and the West in the 21st Century*, is in the mail today.

"Books are great, that's why this quarter we are sending you one"

As an invited guest of Macquarie Bank during the recent Sydney Writers Festival, we were fortunate enough to hear Hutton espouse his thoughts on the prevailing juggernaut that is China. Sounding half credible on the topic and with a desire to learn more about our northerly neighbours, we thought it only prudent that we should donate to Hutton's bank balance while adding to your library as well as ours. Hopefully you will enjoy the read although it can be a bit of a slog in parts. See our story on Hutton's China on page 8.

On a chilly May morning at "Cafe Sydney", Will Hutton, a London pom, ingratiated himself by exclaiming Sydney was the best place on Earth even though he had only been here for a couple of hours.

"at least one US Senator believes a war with China (Iraq -style) is required to diminish the threat to the American way of life"

Hutton went on to note that Australians in general embrace China's growth, harbour no ill-will and perceive little or no threat from this emerging super power. If our financial market's eagerness to embrace China is any gauge, Hutton's view is surely close to the mark!

Yet the mood in America starkly contrasts this. Middleclass Americans see China as a direct threat to job security and future living standards. According to Hutton at least one US Senator believes a war with China (*Iraq -style*) is required to diminish the threat to the American way of life.

With that short introduction we hope you enjoy the read. Needless to say Hutton's view on China does not encompass US popular thought.

"make as few decisions as possible. This is not only a sensible way to invest but one that sits comfortably with us"

On the subject of books, an all time favourite of ours, and one we have mentioned in the past, is Peter Lynch's *One Up on Wall Street* - unfortunately this one is not in the mail.

During his thirteen year tenure running the Fidelity Magellan Fund, Lynch was acclaimed as one of the world's best stockpickers. He was renowned for buying good businesses and holding them for long periods. He wanted to make as few decisions as possible. This is not only a sensible way to invest but one that sits comfortably with us. We'll talk more on this a little later in the issue.

In his book, Lynch recounts anecdotal stories of his investing experiences. In one such incident, Lynch touched on his wife's stockpicking credentials. Carolyn Lynch, who has never worked in financial markets, is a keen shopper and like many women who have balanced the family budgets, has a strong eye for value.

“A pair of panty hose... less likely to ladder”

Lynch explains that Carolyn discovered a new product released by **Hanes** called L’eggs. L’eggs were neatly packaged in an eye-catching colourful plastic egg shaped container and located at grocery store checkouts “right next to bubble gum and the razor blades”. The egg contained a pair of panty hose. These stockings had what they called a heavier denier which made them less likely to ladder or develop a run like the normal stockings. Better still they had superior fit and were comfortable. Carolyn loved the fact that she could pick up a new pair of L’eggs at the mall as opposed to making a special trip to the department store.

Carolyn was obviously also blessed with good communication skills for she was able to educate her husband on a subject in which he had little understanding of and no practical experience. Lynch searched high and low for analyst coverage of this new product and its sales potential. He found none. *(This fact alone probably guaranteed success - Editors comment.)*

In typical Lynch fashion he undertook his own homework at the local shopping mall “coal face”, interviewing passing customers including wife Carolyn and her friends.

As things would have it, **Hanes** turned out to be a “sixbagger” (baseball’s equivalent of a home run or in this case making six times your money) before it was taken over by **Consolidated Foods** now **Sara Lee**. Investors in Lynch’s Magellan Fund did even better. When he finally called it quits in 1990, the Fund had recorded a compound annual return of 29.2% and an original investment of US\$1,000 had grown to US\$28,000.

Not everyone can apply themselves to the task at hand as successfully or as diligently as Lynch’s record would highlight. From Selector’s vantage point it’s all about “investing sensibly”, adopting a

philosophy that takes nothing for granted and by approaching each opportunity with an open mind.

“this is not our flimsy interpretation of how Warren Buffett, Peter Lynch and Philip Fisher do things”

So let’s pose the most obvious questions;

- (1) What do we mean by “investing sensibly”?
and
- (2) Are we as fund managers adding value?

Let’s look at these questions separately. What many people don’t realise is that despite having an investment portfolio of some 1,400 stocks, Peter Lynch’s great track record was largely centered on holding a small number of winning hands, the “tenbaggers” or “twentybaggers” as he was fond of saying. Making only a few right decisions in a big way seems a sensible strategy but requires a little more explanation on our part.

As we see it, to end up with a few right decisions involves a “virtuous circle” of events. We want to be clear upfront, this is not our flimsy interpretation of how Warren Buffett, Peter Lynch and Philip Fisher do things – rather, this is simply how we see things. It’s an investment process that makes sense to us.

Firstly and rather intuitively, in order to be in a position to prosper from a few “winning” hands, the decision not to invest becomes all important.

Since our investment universe encompasses both large and small companies covering a diverse range of businesses, our efforts are directed to those that offer the greatest upside. Several factors assist in deciding who stays and who goes during the filtering process. Experience plays an important role while the “process” itself is crucial. Knowing which businesses deserve backing and which are best left alone requires an investment framework – we have the “road map”.

Our last two quarterly newsletters have been devoted to an explanation of our “road map”. It is a process that has been refined over the years as experience has been gained.

While saying “no” to the myriad of opportunities consumes an inordinate amount of our time (note our calendar diary for companies visited during the quarter), our process is also designed to leave the door ajar for companies that have not yet forced their way in. An example in our calendar diary this quarter is **CathRx (CXD)**.

In a similar vein to Lynch’s “panty hose” experience, we took up the challenge of understanding atrial fibrillation, and the role of **CathRx**, when a family member recently suffered a non fatal stroke that resulted in blood clots travelling to the brain.

We had seen **CathRx** on previous occasions. So we knew a little about the management and the board. This quarter we hosted a meeting in our offices and followed up with a visit to the **CathRx** manufacturing facility at the Australian Technology Park located in Redfern.

Atrial fibrillation is an arrhythmia of the heart or an irregular heart beat. It can cause pooling of blood in the heart cavities that can result in blood clotting. If the pooling occurs on the left side of the heart there is potential for clots to be lodged in the brain since the left side of the heart pumps blood to the brain via the aorta.

Cardiac catheters are routinely used by specialists for diagnosis and treatment of arrhythmias within the right side of the heart. This involves inserting a catheter (*A metal cable and sheath with electrical nodes at and around its tip*) in the femoral artery in the leg and guiding it into the heart. The catheter is then connected to a monitoring system that displays the electrical data associated with heart muscle contraction.

“Has the potential to cut 5 hours off a 6 hour long heart surgery procedure.”

Right side treatment of an arrhythmia involves a technique called ablation – basically using an electric current to scar the heart tissue – which effectively ring-barks the heart muscle. The ability for the heart muscle tissue to conduct electrical impulses across the scarred tissue is removed and accordingly a regular heart beat is re-established. Each ablation is delivered individually in an operation that may last up to six hours - a punishing test of concentration for a surgeon, no doubt.

CathRx has developed the first modular catheter that allows the length and shape of the internal stylet to be adjusted without removing the catheter from the patient. This product has received the CE Mark of approval for sale in Europe. **CathRx** is also a good chance of being first to market with a treatment for the left side of the heart. Furthermore they are developing a “daisy” ablation technique whereby the end of the catheter is opened into a daisy flower shape, vastly increasing the surface area scarred with each ablation. This has the potential to cut 5 hours off a 6 hour long heart surgery procedure.

To date **CathRx** has met all its stated milestones (bar one) and its shares have appreciated accordingly. We see merit in the product and have faith in the people. At this point however, we will continue to watch from the sidelines. **CathRX** is another “no” for the time being. Our reasoning is as follows.

The financial rewards for **CathRX** still appear some way off. Clinical trials are lengthy processes that require significant investor understanding and above all patience. While **CathRx** is more than just a one product company the group has yet to test the market. For us, issues surrounding the industry dynamics, particularly the penetration of markets

dominated by major pharmaceutical companies including Boston Scientific and Johnson & Johnson warrant caution.

Furthermore, for all the hard work we struggle with the lack of potential reward. **CathRx**'s strategy to gain early market share by selling premium products at discounted rates raises some concern. Longer term, and that's how we think, we suspect this may be a flawed or at least a tough strategy to implement. This is one we will continue to watch. And for those readers familiar with our "road map" we are not about to add an "invest for emotional reasons" box to our process.

That brings us to the **Second** part of the "virtuous circle" of "investing sensibly". We approach our research like writing a novel; each company visit adds another chapter to the book. Carrying out extensive company research not only builds on our knowledge database but importantly alerts us to subtle changes in a business. This process gives us enough confidence to hold on to good businesses during turbulent times. We use our "road map" as the frame work for this process. We go through the same process with each of our businesses. As our calendar diary highlights, **Flight Centre** is an example of an interesting meeting that took place during the quarter.

"we have added value by doing what others were less compelled to do. In doing so, our clients have made money from a low risk investment"

In our previous newsletter we noted our reasons for contacting ex-Wallaby front rower and **Flight Centre** Chairman "Bulldog" Bruce Brown. This quarter we visited him in Brisbane. For us this investment typifies our "staying the course" or "do nothing" approach. It's amazing how much work goes into "doing nothing" but holding an investment!

Several clients and industry professionals have questioned us on this investment and we welcome that - not just because things seem to be panning out - but rather that we have added value by doing what others were less compelled to do. In doing so, our clients have made money from a low risk investment that was criticised by many and identified by few.

With the Selector "soap box" pushed to one side, **Flight Centre** is worthy of a few lines of comment. Actually there is a major question to ponder here before we proceed much further.

Why does Pacific Equity Partners (**PEP**) want **Flight Centre** so much?

"This business has been through the valley of death and PEP realise this"

Founded in Sydney in 1998, **PEP** is described as Australasia's leading private equity company. Funds under management are in excess of \$2 billion and include **PEP**'s third Fund which raised \$1.275 billion, representing one of the largest local private equity funds ever raised. It is proposed that the **Flight Centre** investment will be housed in this Fund.

In the past eight years **PEP** have completed over \$3 billion in deals including **Angus & Robertson**, **Godfreys** the recently re-listed **Emeco** as well as partnering, and then withdrawing from, the **Wesfarmers** consortium bidding for **Coles Group**.

The first reason why **PEP** may want **Flight Centre** is the need to spend money or more accurately, invest money to earn fees, but let's be a little less cynical for purpose of this exercise.

A second reason is now playing out. **Flight Centre** has released its second profit upgrade in the past three months. This business has been through the "valley of death" and **PEP** appears to realise this.

And so they should, for **PEP's** CEO and chief architect of the deal is Robert Koczkar who was previously employed at Bain & Co – the consultant **Flight Centre** employed to transform the business under the now abandoned “Full Throttle” project.

This is a dream scenario for private equity. With management having voting control and in agreement, **Flight Centre** is effectively an uncontested deal. And **PEP** benefits from having an intimate knowledge of the business and its potential thanks to the due diligence undertaken by Koczkar during his time as a paid consultant for Bain - no nasty surprises here, **PEP** know it backwards!

The real surprise came when **PEP's** first bid at \$17.00 per share was subsequently “hit for six” by Lazard Asset Management and others who voted down the deal. After taking their bat and ball **PEP** (and management) came back again!

When Bruce Brown referred to tackling smart, slippery operators we're not sure if he was talking about the “All Blacks” or doing business. We just wanted to understand, from Brown, what **PEP** brings to the table other than a capacity to raise lots of debt.

Perhaps the truth lies somewhere in Bryan Frith's article featured in *The Australian* on 15 May 2007, when he noted that “...the \$900M of debt should be substantially paid down within three years, clearing the way for enhanced returns to shareholders...” Brown certainly isn't aware how the debt will be paid off and we think it's highly unlikely that **PEP** will show their hand just yet.

On our numbers and with a tailwind behind the business, the current \$19.50 market price has **Flight Centre** on an earnings per share projection of \$1.24c in 2008 giving rise to a price to earnings ratio of 15.7x dropping to 14.4x if we assume sub 10% growth in 2009. Throw in a yield of close to 4% and these are not demanding numbers for a debt free business with growth potential north of 15% per annum. Under these circumstances not only

would this underpin the group's current valuation, it could well give rise to a higher market rating.

“Global opportunities are fantastic. If PEP is any good, they will have a huge impact on the business”

Investors should think of this deal in two parts. The first relates to the establishment of a JV company where **Flight Centre** shareholders own 70% of the equity and **PEP** own the 30% balance. The JV vehicle will borrow \$960 million and **PEP** will inject \$195 million to take up its 30% portion of equity, resulting in a total cash position of \$1.15 billion in the JV vehicle.

The second part involves the listed **Flight Centre** company selling its entire business into the JV vehicle for a cash consideration of \$1.15 billion – a straight swap if you like.

This deal will result in the JV vehicle starting life highly leveraged, with a debt position of \$960 million. As for the listed **Flight Centre** group, their starting cash position will consist of \$1.15 billion less a capital gains tax bill of around \$300 million, leaving the group with around \$855 million to distribute via its buy-back program.

And here it gets interesting. Depending on the level of acceptances received during the buy-back, it is highly likely that **Flight Centre** will be left with a sizable cash balance.

On our numbers, if the founders sell their maximum 22 million shares into the buy-back and the balance of minorities accept for 50% of their holding, total cash consumed would amount to \$672 million (at \$16.00 per share buy-back offer), leaving \$185M in the kitty. Ultimately management will determine what level of cash should be retained to meet any JV capital commitments but if \$150 million was deemed as surplus, we could see a further \$3.00 per share paid out to remaining shareholders (52 million) post the buy-back

While many things are still up in air, what Bruce Brown did make very clear to us was the strong knowledge that **PEP** already had of the **Flight Centre** business. No surprise here! It appears that their value add will come from strategy input at the business end as well as helping **Flight Centre** founder Graham Turner set in train a course of action that will ultimately allow him to pass the baton. Importantly Turner wants to work with **PEP**, a point highlighted by Brown while also noting that for **Flight Centre** the “Global opportunities are fantastic. If **PEP** is any good, they will have a huge impact on the business”

Despite these uncertainties, we have put a lot of work into understanding what we see as the big picture issues. That’s the essence of the second part of the virtuous circle of “investing sensibly”.

The homework that we undertook not only gave us the confidence to “do nothing” at crucial times but also allowed us to add to our **Flight Centre** position when other investors deemed it unfavorable.

We hope to use the same logic when deciding to either accept the offer or stay in partnership with the **PEP** and **Flight Centre** founders.

That leads us to our final point on our “virtuous circle” tour. A consistent investment approach will not only help to separate fact from fiction, making the *not* to invest case a lot clearer, it also provides the confidence to *stay the course, and do nothing* when required – leading us back to where we started.

Peter Lynch noted that the difference between an average investor and a great investor need only be one or two decisions. Our own investing experience certainly supports this view. For us it makes sense to;

1. Focus the investment dollars on a few good businesses for the long term.
2. Undertake well founded research that provides the platform to invest with

confidence, often contrary to prevailing market views.

3. Apply a consistent process - for us the “road map” is the starting point.

Ultimately it is the combination of these factors that in our view adds value for our clients. The ability to “stay the course and do nothing” when it is unfashionable may be both emotionally and financially unpleasant in the short term but often leads to out performance over the long run.

Importantly the “virtuous circle” path rules out a few things, namely;

1. Trading (*not a great outcome for stockbrokers or the Tax Office*)
2. Investing in things we are unsure about even though gains are likely to flow in the very short term (*lots of examples exist*)
3. Investing in interesting businesses that have not been adequately researched (*plenty of examples – the reality of being a small team*)

So finally, let us pose the most important question. How does a client measure Selector’s ability to add value?

Hopefully, by adopting some of the methods we use in rating an investment. Look for the consistency in our approach and the honesty in reporting the facts. Read the newsletter, note down a few milestones and measure our long term performance against them.

And remember, the opportunity always exists for our clients to do some research on us, by dropping in for a chat. Now how many fund managers can you do that with? *SFM*

A green story with growth and economics

Late in the quarter we attended the UBS Energy & Utilities conference. **Babcock & Brown Wind Partners Group (BBW)** CEO Miles George

caught our attention. Softly spoken and wearing a tie he was definitely not from the typical **Babcock & Brown (BNB)** mould. Our interest stems from the fact that our clients (via the Fund) have a defacto ownership of **BBW** through the **BNB** mothership. We became investors on the day of the **BNB** listing, paying what then seemed a healthy premium to its IPO price.

We learnt that global wind power capacity totaling nearly 75,000 megawatts currently generates just 1% of global electricity consumption and that the windy parts of the planet have the potential to generate up to 20% of global energy requirements.

The World Wind Energy Association (WWEA) predicts global installed capacity will be 160,000 MW by 2010. In fact the industry has been growing at 28% per annum over the past 10 years.

BBW has 33 wind farms operating or under construction, producing 1,439MW and placing them amongst the world's top 5 owner operator groups. Currently the **BBW** development pipeline represents an additional 3,000MW.

The growth sounds great but what about the profits and the escalating development cost profile?

At the asset level there are reasons to be impressed. Not dissimilar to toll roads, these are very high margin assets, highlighted in blue below. We note that these numbers are before depreciation expenses.

Table 1: EBITDA Margins by operating regions

Australia	IPO 06 (F)	FY 06 (A)	H1 07 (A)
<i>EBITDA Million</i>	\$26.9	\$30.0	\$18.3
<i>EBITDA margin</i>	79.8%	83.6%	82.8%
Germany	IPO 06 (F)	FY 06 (A)	H1 07 (A)
<i>EBITDA Million</i>	\$3.9	\$4.7	\$5.2
<i>EBITDA margin</i>	79.5%	80.1%	73.1%
Spain	IPO 06 (F)	FY 06 (A)	H1 07 (A)
<i>EBITDA Million</i>	\$39.4	\$32.4	\$21.3
<i>EBITDA margin</i>	85.5%	79.9%	84.5%

Importantly, the majority of **BBW's** wind farms are less than 5 years old and the capital expenditure requirements to service these are forecast to be low for the foreseeable future. And whilst cost escalations of circa 20%-30% are of some concern, these have been more than offset by the strong growth in revenues and margins being generated.

Lastly, in a world awash with liquidity, **BBW's** use of debt to fund the bulk of the group's expanding global footprint requires particular caution. This is why we prefer to be in the mothership rather than the satellites. The bulk of debts in the satellites are non recourse to the risk adverse **Babcock & Brown** company. *SFM*

Word of Warning: The Growing Use of "Data Rooms"

Lately it has become fashionable for companies and boards to look for an exit when things aren't too flash. Usually released under the heading of "strategic review", this is really code for "we're in trouble". Next step is to get the consultants in too confirm that you are in trouble. And lastly you put up the "for sale" sign, never wanting to confirm that you really are up for sale.

Recently the trend has turned to the use of "data rooms" where interested parties are invited to inspect the books of a business before taking the plunge of actually bidding. So far the results have been far from stellar. The **Coles Group** has been at it for months and as we go to print it looks like there is only one bidder for the whole company after a torturous four-month process.

Another to recently join the "data room" club is **Coates Hire**. Their release to the market on 28 June was particularly disconcerting as to why a data room was being opened, "The Board is of the opinion that a formal assessment of indicative proposals by means of a due diligence process will give us a better understanding of the value of available offers". What gobbledegook!

And finally we would like to put our hat in the ring and suggest that the next to open a “data room” will be drugs wholesaler **Australian Pharmaceutical Industries**. Despite all the talk of improving outlook the numbers just don’t stack up and major shareholders including **Washington H Soul Pattinson** look poised to jump ship. *SFM*

Hutton’s China

Often a “big picture” event is such that the details lose their relevance. In the case of China this may not be so. Here the devil may well be in the detail. And the detail may be the economic imbalances that extraordinary growth delivers.

Try these few “big picture” extracts from Hutton’s book for size.

“China’s economy is nearly nine times larger than it was in 1978, and is the fourth largest in the world, after the United States, Japan and Germany.

If current trends continue it is set to become the second largest within a decade. The only comparable rise is that of the United States at the end of the nineteenth century. Between 1981 and 2001, 400 million Chinese people had been bought out of poverty. Between 1978 and 2003, the average per capita income rose by a multiple of six. The proportion of the population living in towns and cities has doubled to nearly two-fifths. Up to 150 million workers have moved to China’s booming cities – the biggest migration in history. It is a head-spinning achievement.”

Head spinning it may be but Hutton reckons they are only half way through!

“Stronger for longer” is now synonymous with China. Yet Hutton also notes that China has simply completed the easy bit. The tough bit comes in transforming productivity gains without causing the financial melt down of the state. And here Hutton issues a word of caution. The path that China is on

is unsustainable on many fronts.

Hutton suggests the Chinese ruling party is aware of the unsustainable economic trajectory and steps are being taken to address imbalances.

But as Hutton points out only time will tell “*whether the twenty-first century is going to be the Chinese century in the way the twentieth century was American and the nineteenth century British*”.

Hutton’s views on the threats facing China are large and should not be underestimated; he believes a regime change with the fifth generation of communist leaders, in autumn 2007, may be a critical catalyst for economic reform.

We think Hutton’s words are refreshing in that they present the flip side of the extraordinary growth that many are taking on face value alone. *SFM*

Sub prime explained...some what.

Sub prime mortgage defaults in the US have grabbed headlines over the past six months and have been held responsible for financial turmoil ranging from credit market meltdowns to hedge fund collapses and even multiple private equity withdrawals from the **Coles Group** data rooms.

“rating agencies...How...can they justify their fees?”

Like all financial products where rating agencies are involved - this market is awash with acronyms. How else can they justify their fees? More on that later.

During the quarter we joined a conference call with Chris Flanagan, Managing Director of Global Structured Finance Research at JP Morgan in New York. Flanagan went some way to decoding the jumble.

The US mortgage market is some \$10 trillion in size. The bottom 15% totalling \$1.5 trillion is the lowest credit quality or sub prime market. That is, borrowers who are considered a higher credit risk, as they are unable meet conventional bank requirements to secure a mortgage at market rates.

In the past seven years the sub prime market has seen staggering growth. Sub prime credit approval ballooned from \$100 billion in 2000 to a peak of \$800 billion written in 2005 followed by \$700 billion in 2006. This was largely fuelled by rampant HPA, our first acronym.

Home Price Appreciation (HPA) crept into double-digit figures post the 2001 NASDAQ technology bubble meltdown.

***“...market observed
...performance...capital flooded in”***

In 2002, HPA recorded a rise of 11% followed by consecutive rises of 17.5% in both 2004 and 2005. This rapid growth in HPA enabled many sub prime borrowers to refinance and establish some level of equity in properties that generally began with 80% - 100% LVR's or Loan to Valuation Ratio's. This worked a treat for sometime.

The market observed the better than expected performance of the sub prime borrowers and capital flooded in by way of securitisation in the form of CDO's, CMO's and CLO's. Acronym 3, 4 and 5.

Collateralised Debt Obligations (CDO's) are a type of asset backed securities and structured credit products. The underlying asset is a pool of mortgages that have a range in credit ratings from AAA to CCC- (sub prime is B paper and below) and may include equity tranches. The credit ratings are provided by rating agencies such as Standard & Poor's and Moody's.

Collateralised Mortgage Obligations (CMO's) are a type of mortgage-backed security that creates

separate pools of pass-through rates for different classes of bondholders with varying maturities, called tranches. The repayments from the pool of pass-through securities are used to retire the bonds in the order specified by the bonds prospectus.

Here is an example how a very simple CMO works: Investors in the CMO's are divided into three classes. They are called Class A, B or C investors. Each Class differs in the order they recoup the principal invested with interest payments ongoing until the entire outstanding principal is repaid. Class A investors are first in line to recoup their entire principal followed by Class B and lastly Class C. In a situation like this, Class A investors while ranking first in security terms also bear the risk of recouping their capital much earlier than originally intended while Class C investors bear the least.

Collateralised Loan Obligations (CLO's) are identical to CMO's except for the assets securing the obligation. CLO's allow banks to reduce regulatory capital requirements by selling large portions of their commercial loan portfolios to international markets, reducing risks associated with lending.

***“performance
...deteriorated...support from
investors evaporated”***

Financial houses issue the CDO's and CMO's to investors, generally hedge funds such as those bailed out recently by Bear Stearns. Hedge funds are attracted to the higher yields relative to the credit risk. And if you want a scary book about hedge funds, try *“Hedgehogging”* by Barton Biggs – thanks Grant.

According to Chris Flanagan demand for CDO's has been a major driver of the sub prime market. It is also the reason why credit markets are now feeling the brunt of the sub prime fallout.

By 2005, HPA had made home prices unaffordable. Lax credit standards in 2005 and 2006 resulted in home prices peaking in June 2006. New sub prime borrowers were defaulting within 2-3 months of executing contracts. In late 2006 delinquency rates were double that of 2004 and 2005.

As credit performance of the loans deteriorated the support for homebuyers' from investors evaporated putting further pressure on the housing market.

“Ratings from these respected rating agencies where not relevant. BBB- became CCC-.”

Financial markets focused on the US ABX, an index composed of 20 asset-backed securities. Each security has a rating from “respected” ratings agencies. In January 2007 the BBB- index, a component of the ABX fell from a par of 100 to 60. A forty percent decline in the space of one month.

It was at this point that financial markets realised that the ratings from these “respected” rating agencies where not relevant. BBB- became CCC-. The subsequent credit crunch resulted in the collapse of New Century Mortgage Corporation one of the US's largest non-prime mortgage finance companies.

Markets stabilised for several months until a sharp decline in May 2007 resulted in further repricing of bonds.

So what is the likelihood of contagion, the so-called knock on effect?

“In relation to financial markets he thought contagion was a more interesting question.”

In terms of consumer credit fundamentals Chris Flanagan felt this would not be a significant issue. His reasoning is that the sub prime market is the

bottom 15% and up to 80% of that market is relatively stable. This leaves at risk \$100 - \$200 billion of mortgages. Flanagan suggested, “On a grand scale this is relatively small”.

Flanagan also cited the very low US unemployment rates, 1%-2% for highly educated and 6%-7% for the uneducated, as a key support to consumer credit.

In relation to financial markets he thought contagion was a more interesting question.

Basically credit markets are calling for more collateral against assets due to there declining value. This pressure is driving margin calls, which drive more selling.

CLO margins are being raised and this increases the cost of capital in loan markets. Interest rate spreads move higher and the cost to do an LBO, leveraged buyout, increases. Hence, the private equity exodus from the **Coles Group** data room.

Flanagan finished with what he called a word of “caution”. We were actually surprised by his bullish tones. “Fundamentals in loan markets still remain very strong. There is increased liquidity premium but credit costs will remain low. The LBO boom is a function of global growth”.

He even suggested that despite the severe pressure currently underway in US housing prices we could see some recovery 3 to 4 years out.

Finally in relation to the credit rating agencies, we were interested to learn that Fortune Magazine editor at large Bethany McLean, famous for blowing the whistle on **Enron** and co author of “*The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*” in an interview with the “The Intelligent Investor” sees rating agencies as the next big scandal.

No disagreement from us. *SFM*

COMPANIES VISITED DURING THE 4th QUARTER 2006-2007

April

SAI	SAI Global briefing	2-04-07
SRX	Sirtex Medical Site visit	3-04-07
DMX	Dolomatrix International management meeting	3-04-07
QBE	QBE Insurance Group AGM	4-04-07
WSA	Western Areas briefing	18-04-07
TPI	Transpacifc Industries Group conference	18-04-07
GWT	GWA International conference	18-04-07
EHL	Emeco Holdings conference	18-04-07
BOL	Boom Logistics conference	18-04-07
AUW	Australian Wealth Management conference	18-04-07
EBB	Everest Babcock & Brown conference	18-04-07
MOC	Mortgage Choice conference	19-04-07
PGA	Photon Group conference	19-04-07
SEK	SEEK conference	19-04-07
N/A	Emitch conference	19-04-07
AUN	Austar United Communication conference	19-04-07
MFS	MFS conference	19-04-07
WYL	Wattyl conference	19-04-07
BKW	Brickworks conference	19-04-07
MBR	Mariner Bridge conference	19-04-07
RMD	Resmed 3rd quarter briefing	24-04-07
RMD	Resmed management briefing	30-04-07

May

ALL	Aristocrat Leisure conference	1-05-07
TLS	Telstra conference	2-05-07
SIP	Sigma conference	2-05-07
REF	Reverse Corp conference	2-05-07
WOR	WorleyParsons conference	2-05-07
MMS	MacMillan Shakespeare conference	2-05-07
PRY	Primary Healthcare conference	2-05-07
WOW	Woolworths conference	3-05-07
COH	Cochlear conference	3-05-07
TRS	The Reject Shop conference	3-05-07
AGK	AGL Energy conference	3-05-07
MBR	Mariner Bridge management meeting	3-05-07
TAH	Tabcorp conference	4-05-07
ARQ	ARC Energy conference	4-05-07
ROC	ROC Oil conference	4-05-07
ALL	Aristocrat conference	4-05-07
QBE	QBE Insurance conference	4-05-07
CUO	CopperCo conference	4-05-07
CBH	CBH Resources conference	4-05-07
ABS	ABC Learning conference	4-05-07
ROC	ROC Oil AGM	10-05-07
MBL	Macquarie Bank FY Result	15-05-07
PSA	Petsec Energy AGM	17-05-07
CXD	CathRx management meeting	21-05-07
COO	Corum Group site visit	22-05-07
FPH	Fisher & Paykel Healthcare FY results	23-05-07
BKL	Blackmores site visit	23-05-07
BNB	Babcock & Brown AGM	25-05-07
CCP	Credit Corp briefing	25-05-07
ABB	ABB Grain briefing	28-05-07
SYB	Symbion takeover briefing	29-05-07
ROC	ROC Oil site visit	31-05-07

COMPANIES VISITED DURING THE 4th QUARTER 2006-2007
June

GNC	Graincorp briefing	1-06-07
PAB	Patrys IPO presentation	5-06-07
CXD	CathRx site visit	12-06-07
UBI	Universal Biosensors management meeting	14-06-07
CCP	Credit Corp site visit	14-06-07
BNO	Bionomics management meeting	15-06-07
WSA	Western Areas conference	18-06-07
AWC	Alumina conference	18-06-07
IGO	Independence Group conference	18-06-07
SMY	Sally Malay Mining conference	18-06-07
RMD	Resmed site visit	19-06-07
COH	Cochlear site visit	19-06-07
KZL	Kagara Zinc Management meeting	19-06-07
PEM	Perilya conference	19-06-07
JML	Jabiru Metals conference	19-06-07
ABY	Aditya Birla Minerals conference	19-06-07
SIP	Sigma Management meeting	20-06-07
PPT	Perpetual conference	20-06-07
MBL	Macquarie Bank conference	21-06-07
BNB	Babcock & Brown conference	21-06-07
SGB	St George Bank conference	21-06-07
AGK	AGL Energy conference	26-06-07
N/A	TRU Energy conference	26-06-07
BBP	Babcock & Brown Power Generation conference	26-06-07
JGL	Jackgreen Energy conference	26-06-07
BBI	Babcock & Brown Infrastructure conference	26-06-07
BBW	Babcock & Brown Wind Partners conference	26-06-07
APA	APA Group conference	26-06-07
QGC	Queensland Gas Company conference	26-06-07
AOE	Arrow Energy conference	26-06-07
ORG	Origin Energy conference	26-06-07
WPL	Woodside Petroleum conference	27-06-07
STO	Santos conference	27-06-07
OSH	Oil Search conference	27-06-07
AWE	Australian Worldwide Exploration conference	27-06-07
ROC	ROC Oil conference	27-06-07
BPT	Beach Petroleum conference	27-06-07
WPL	Woodside Petroleum conference	27-06-07
N/A	NRW IPO	28-06-07
API	Australian Pharmaceutical Industries FY result	28-06-07