SELECTOR Funds Management

SELECTOR FUND
Quarterly Report - 31 December 2006
[Issue No.14]

FUND PERFORMANCE

Since inception in November 2004 the Fund has delivered a net return of **95.82%** to 31 December 2006 inclusive of **$0.0555** cents in total distributions to unit holders, out performing the All Ordinaries Accumulation Index, which has risen by 62.59% over the same period. Statistics page 8. ***SFM***

BIG PICTURE

"Diworsification"

We hold 15-20 stocks in the Fund. We have a concentrated portfolio. Full stop, pretty simple. These days however the "cool" term is "high conviction" or even "alpha". So if you read these terms in the financial press or while playing ***Second Life*** *, don't pay too much attention because they are likely to change as soon as the next cold wind blows.

Still it begs the question, how did Selector come to being so cool? And if "high conviction" is as cool as Second Life , it must be new - surely?

Well, the answer to the first is pretty subjective and after a bit of digging possibly a bit deflating. But, the answer to the second question is more definitive and can be found in the lessons of economic history.

> ***"The father of modern economics John Maynard Keynes was homosexual"***

It was of interest to us when we learned that the father of modern economics John Maynard Keynes (1883 - 1946) was homosexual as noted in the biography of Keynes, titled ***Hopes Betrayed*** by Robert Skidelsky.

**Second life created by Linden Lab is an MMO, "massively multiplayer online game" with its own economy and currency called Linden Dollars that convert to US$'s. Players pay a monthly subscription fee to build, buy & sell digital assets and virtual land. Some of the more than 2.3M "residents" have become millionaires doing so (The Economist). People spend 10's of hours a day playing Second Life! www.secondlife.com/whatis/economy_stats.php*

We have no doubt that if this fact was more widely known a significant portion of Sydney's adult community would celebrate his existence.

Yet for decades it remained a closely guarded secret. The simple fact that Keynes was prepared to be different in a very conservative society was unique and encouraged us to read on.

At the age of thirteen Keynes was awarded a scholarship to Eton where he went on to amass 63 academic prizes. This success was followed by a scholarship to Kings College at Cambridge where Keynes was influenced by Alfred Marshall, the great Victorian economist who took Keynes under his wing.

> ***"I want to manage a railway or organise a Trust or at least swindle the investing public"***

Keynes's early success taught him how to "win", an attribute he would carry for life. Not surprisingly the young Maynard Keynes (only his mum called him John) developed an ego and the potential to make the late Rene Rivkin look amateurish.

In a letter to Peter Strachey, the 22 year old Keynes wrote, "I find economics increasingly satisfactory and I think I am rather good at it. I want to manage a railway or organise a Trust or at least swindle the investing public".

Either Keynes had a sense of humour, or he carried heavily the burden of societal prejudices at such an early age.

As history now records, Keynes attained great heights in his public life. As a director of the Bank of England he was a central figure in dealing with the economic fallout of the Great Depression.

Later he became the chief economic representative for Great Britain during its negotiations with the United States at the end of World War II, and was a major architect of the post war international monetary system.

Yet according to Skidelsky, close associates and early biographers believed they needed to conceal Keynes's "secrets" in order to protect the important public acceptance of his economic theory and other work.

Today, next to Adam Smith, John Maynard Keynes, author of ***The general theory of employment, interest and money***, the book that changed thinking on capitalism, is celebrated as being the most influential economic thinker in modern history.

So why is Keynes's sexuality of interest to us?

Skidelsky points out, "that by down playing key aspects of Keynes's life, including his homosexuality, previous biographers didn't give as vivid and true portrait of the man as was justified. It made him out to be less creative and less interesting than he truly was… If you paint Keynes as a conventional man, and picture his personal affairs in those terms, then you are not prepared to understand his break with convention in other areas. Keynes had a subversive attitude towards a whole range of Victorian morals and conventions which enabled him to see economic problems in a very unusual way."

"A mistake to think one limits one's risks by spreading too much between enterprises"

It is this last point that holds interest for us. Having not met Keynes we are interested in learning about the various factors that influenced his independent thinking. Clearly his willingness to challenge convention combined with his crushing intellect was a powerful combination.

As a celebrated economist, what made Keynes so interesting was his ability to make money. Keynes was in fact a great fund manager. This is a major break from convention for any economist.

As first bursar of Kings College at Cambridge University, Keynes was responsible for the Chest Fund from 1927 until his death in 1946. Early on Keynes persuaded the trustees to expand the asset class from fixed interest to include common stocks or shares. This break from convention worked a treat.

"Keynes's economic theories actually worked"

As a fund manager Keynes returned 13.2% annually against the UK market index return of – 0.5% over an 18 year period. This is a great return made even more remarkable by the fact that this period included the Great Depression and World War II. Keynes's economic theories actually worked in the real world!

Annual Percentage change (%)		
Year	Chest Fund	UK Index
1928	0.0	0.1
1929	0.8	6.6
1930	-32.4	-20.3
1931	-24.6	-25.0
1932	44.8	-5.8
1933	35.1	21.5
1934	33.1	-0.7
1935	44.3	5.3
1936	56.0	10.2
1937	8.5	-0.5
1938	-40.1	-16.1
1939	12.9	-7.2
1940	-15.6	-12.9
1941	33.5	12.5
1942	-0.9	0.8
1943	53.9	15.6
1944	14.5	5.4
1945	14.6	0.8
Average Return	**13.2%**	**-0.5%**

J M Keynes track record as a fund manager 1928-45 **The Warren Buffett Portfolio** *by Robert G Hagstrom.*

Keynes's approach was simple, and best highlighted by a letter he wrote to FC Scott, a business associate in 1934. "It is a mistake to think one limits one's risks by spreading too much between enterprises about which one knows little and has no special confidence… One's knowledge and experience are definitely limited and there are seldom more than two or three enterprises at any given time in which I personally feel myself entitled to put full confidence". **

Keynes's simple logic inspired some of the world's greatest investors including Philip Fisher and Warren Buffett.

In fact, Philip Fisher seems to have taken his lead directly from Keynes. In his 1958 best seller ***Common Stocks and Uncommon Profits***, Fisher wrote, "It never seems to occur to investors, much less their advisors, that buying a company without having sufficient knowledge of it may be even more dangerous than having inadequate diversification"

"Once a strong opportunity was identified the only reasonable course was to make a large investment"

Fisher believed that "once a strong opportunity was identified, using a thorough and consistent process, the only reasonable course was to make a large investment."

In the introduction to *Common Stocks and Uncommon Profits,* Fisher's son Ken Fisher (*Author of "Portfolio Strategy" the sixth longest running column in Forbes Magazine*) points out, "My Dad saw what it ment to have a large position in something that paid off"

*** Berkshire Hathaway Annual Report, 1991 page 15. http://www.berkshirehathaway.com/letters/1991.html (near the bottom)*

"You should have the courage and the conviction to place at least 10 per cent of your net worth in that stock"

Like Fisher, Warren Buffett echoes Keynes's thinking: "With each investment you make you should have the courage and the conviction to place at least 10 per cent of your net worth in that stock".

Buffett's theory is that a policy of portfolio concentration will decrease risk if it raises the intensity with which an investor thinks about a business and increases the comfort levels an investor must feel with the business fundamentals before an investment is made. Buffet goes on to add, "Diversification only serves as protection against ignorance".

A "concentrated portfolio" inherently has three other characteristics that should be noted. **Firstly**, and most notably, it is the opposite approach to a broadly diversified, high turnover strategy.

Secondly, of all active investment strategies a concentrated portfolio has the best chance of outperforming an index over time. We will draw on a study from ***The Warren Buffett Portfolio*** by Robert G Hagstrom to provide the supporting evidence to this statement shortly.

But, (there's always a but) it requires an investor to hold the portfolio even when it appears other strategies are marching ahead. Only as the time horizon lengthens can the underlying fundamentals of a business be reliably expected to dominate a businesses share price.

And there is no hard and fast answer to the question of how long is that ideal time line. At Selector we have simply said 5 years is a good starting point. Philip Fisher suggested that 3 years should be his judgement period. Buffett is more definitive in stating he never intends to sell a business and that "any span shorter than 5 years is a fool's theory".

"A concentrated portfolio like ours provides a bumpy ride"

The **third** characteristic of note in a "concentrated portfolio" is volatility. As most of our readers know we love to hammer this home. Price volatility is a necessary by product of a concentrated portfolio.

A broadly diversified portfolio has the effect of smoothing the gains and losses. This provides comfort to many investors. But a smooth ride is also a flat ride.

A "concentrated portfolio" like ours provides a bumpy ride. Simply put the winners have a big impact and the losers have an impact as well. (See our page 6 column, *Point of Interest*.)

Now have a look back at the bumps Keynes's portfolio endured! Keynes's portfolio was 3 times more volatile than the UK index. And while the first 4 years may be a bit ugly, imagine if the trustees pulled the plug and missed out on the next 5 years. That would have been disastrous!

Obviously stock selection is crucial, but the simple mathematics also needs to be understood. Latch onto a winning business and the upside enjoyed is only limited by the confidence to hold the position and management's ability to nurture its progress. Stocks that can deliver five to ten times your investment dollar (ten baggers as termed by Peter Lynch) actually occur far more frequently than many imagine but too often, an investor's impulse to jump ship midstream deprives them of significant profit.

On the other hand, a portfolio holding some real dogs might see these investments halve in value or even worse go out the back door. As painful as that may be, the dollar loss is contained to the amount invested. Hopefully, for us, some road signs (warnings) are recognised and heeded long before the latter occurs. Obviously the overall aim is to see the portfolio bump up more than down.

Robert G Hagstrom in ***The Warren Buffett Portfolio*** provided some hard evidence in support of a "concentrated portfolio". Using a database, Hagstrom isolated 1,200 companies with measurable data including earnings and return on equity (two areas of focus on our roadmap) from 1979 to 1986. The computer was then programmed to randomly assemble from the 1,200 companies 12,000 portfolios as follows;

1. 3,000 portfolios containing 250 stocks
2. 3,000 portfolios containing 100 stocks
3. 3,000 portfolios containing 50 stocks
4. 3,000 portfolios containing 15 stocks

The rate of return for each portfolio was calculated for 10 year and 18 year periods and compared to the Standard & Poors 500 Price Index. The key finding was that in every case as the number of stocks in the portfolio was reduced the probability of generating returns greater than the market increased.

All four portfolio groups had an average return of 13.8% while the index returned 15.2%. It was noted by Hagstrom that the index was dominated by large capitalisation stocks which did particularly well during the period while the "laboratory stocks" had a balance of large, medium and small capitalisation stocks.

The best performing and worst performing portfolios in each group were then analysed.

1. Among the 250 stock portfolios, the best return was 16.0 percent and the worst was 11.4 percent
2. Among the 100 stock portfolios, the best return was 18.3 percent and the worst was 10 percent
3. Among the 50 stock portfolios, the best return was 19.1 percent and the worst was 8.6 percent
4. Among the 15 stock portfolios, the best return was 26.6 percent and the worst was 4.4 percent

***Note: Stock selection plays the critical role here**

The same relative trends were found in the 18-year period. The "concentrated portfolios" showed much higher highs and lower lows than the broadly diversified portfolios. The clear conclusions are

1. You have a much higher chance of outperforming the market with a "concentrated portfolio"
2. You have a much higher chance of performing worse than the market with a "concentrated portfolio"

To reinforce the first point the following statistics were produced by Hagstrom.

- Out of 3,000 15 stock portfolios, 808 outperformed the market
- Out of 3,000 50 stock portfolios, 549 outperformed the market
- Out of 3,000 100 stock portfolios, 337 outperformed the market
- Out of 3,000 250 stock portfolios, 63 outperformed the market

Hagstrom noted that trading expenses were not factored in and have obvious consequences in the 250 stock portfolios.

The second conclusion is important and is often overlooked. It reinforces the significance of *stock selection. Stock Selection is key and our main focus. We have tried to provide some hard data to highlight this in "*Point of Interest*" below.

"High conviction or alpha investing has been around for donkey's years! It just been hiding"

Now in summing up. We posed two questions. As indicated the answer to the second is definitive. It is pretty clear "high conviction or alpha investing" has been around for donkey's years! It just been hiding under the boring old guise of a "concentrated portfolio".

In fact our rambling history lesson has traced "high conviction investing" back to arguably one of the greatest independent thinkers of his times in John Maynard Keynes. A man whom, as we discovered, was clearly prepared to walk his own path. Something, we believe, should not be discounted, but rather investigated in whatever form it manifests.

Better still, "high conviction investing" has been time tested and has been the cornerstone of some great and successful investing, often flowing from very humble starts.

Sadly, in relation to the first question we incorrectly believed the answer was subjective. It's now clear our history lesson also debunks the home grown theory that Selector Fund is "cool". Applying an investment philosophy that has been around for donkey's years is hardly any match in the "cool" stakes for the likes of *Second Life*.

We're pretty comfortable with this finding. From the outset we have run a very vanilla long only managed fund investing in Australian businesses. We are stock selectors and our aim remains to select a few of the best businesses run by the best management teams we can find and to concentrate the bulk of our funds in those business. We like to hold our investments for as long as possible. As a result we aim to compound at 15% per anum over the long term.

As our history lesson shows a "concentrated portfolio" it is a tried and tested method that works over a long period of time. An important point to note is that when the cold wind blows it is felt by all but some see it as an opportunity and Keynes's track record on page two is a great example of this.
SFM

Point of interest

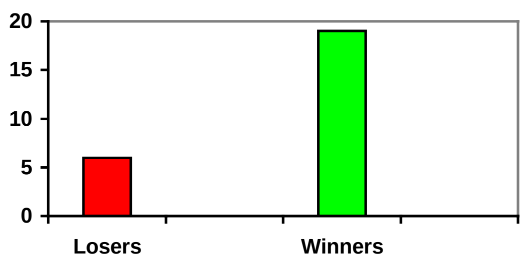
Regular readers will notice we rarely comment on performance. We simply don't think it adds much value in the short term.

That said we recently came across some performance related statistics presented by another manager, which we believe are an interesting way to look at our business, ***the importance of stock selection*** and the benefits of a concentrated portfolio. So we thought they are worthy of sharing with you.

It should be noted that we are presenting both realised and unrealised gains since inception. We believe the figures are on the conservative side because we have ignored dividend income.

Since inception we have invested in a total of 25 businesses and have sold 5 to date. Statistically, 19 have been winners and 6 have sat on the losing side of the ledger. In percentage terms, measured purely on individual share prices paid in comparison to the current realised or unrealised value of each business bought, 76% have generated positive returns.

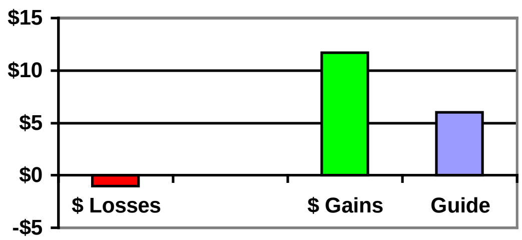
Selector Fund
Losers vs Winners
Since Inception



Put another way, for every $1.00 lost we have made gains of $11.72 in the Fund. This reflects the Fund's performance period since inception over the past two years and two months representing a **compound** annual return of 35.92%.

No doubt the strong bull market that has propelled many valuations northward has contributed strongly.

Selector Fund
$ Loss vs $ Gain
Since Inception



It would be arrogant of us not to expect our loss/ gain ratio to pull back to around $1 to $6. Such levels are more in keeping with less buoyant times but still represent a good batting average. ***SFM***

Out & About

While our Big Picture story highlighted our "concentrated portfolio" approach, getting confidence to invest involves a great deal of digging around. As our diary below illustrates, we spend large chunks of our time meeting with as many management teams as possible.

Whether it's our first introduction or adding another "chapter" to our research, we never tire of learning something new. And occasionally we are even blessed with some pearls of wisdom, which reveal more of the intellectual capital within a business than any raw profit numbers will ever divulge. Here are two we liked this quarter.

Allan Moss - *Macquarie Bank CEO*

"We don't have hard targets. We have aspirations"

A response to an analyst's request for some long range earnings guidance at the group's November half year results presentation.

Dick McIlwain – *Tattersalls CEO*

"I like simple businesses that have few moving parts"

Highlighting why the wagering and gaming businesses like Unitab and now Tattersalls are such wonderful businesses to own and run. ***SFM***

COMPANIES VISITED DURING THE 2nd QUARTER 2006-2007

October

N/A	**Crazy John's** presentation	04-10-06
TLS	**Telstra** Investor Day	06-10-06
ASX	**Australian Securities Exchange** AGM	09-10-06
ALU	**Altium** AGM	10-10-06
ACL	**Alchemia** Biotechnology Conference	16-10-06
ACR	**Acrux** Biotechnology Conference	16-10-06
BTA	**Biota** Biotechnology Conference	16-10-06
COH	**Cochlear** Biotechnology Conference	16-10-06
HSP	**Healthscope** Biotechnology Conference	16-10-06
HTW	**Heartware** Biotechnology Conference	16-10-06
PXS	**Pharmaxis** Biotechnology Conference	16-10-06
PEP	**Peplin** Biotechnology Conference	16-10-06
SHL	**Sonic** Biotechnology Conference	16-10-06
SHC	**Sunshine Heart** Biotechnology Conference	16-10-06
TEN	**TEN Network** Results briefing	18-10-06
AUW	**Australian Wealth Management** Briefing	18-10-06
BOQ	**Bank of Queensland** Briefing	18-10-06
HFA	**HFA Holdings** Briefing	18-10-06
SEK	**Seek** briefing	19-10-06
FZN	**Fone Zone** briefing	19-10-06
SAI	**SAI Global** AGM	20-10-06
WOW	**Woolworths** 1st Quarter results	23-10-06
SRX	**Sirtex** AGM	24-10-06
COH	**Cochlear** AGM	24-10-06

November

ROC	**ROC Oil** Briefing	03-11-06
RPX	**RP Data** IPO briefing	06-11-06
ACG	**Atcor** Management visit	07-11-06
CBH	**CBH Resources** AGM	10-11-06
TLS	**Telstra** AGM	14-11-06
CCV	**Cash Converters** Briefing	14-11-06
MBL	**Macquarie Bank** Results briefing	14-11-06
FPH	**Fisher & Paykel Healthcare** Briefing	15-11-06
RMD	**Resmed** Healthcare conference	16-11-06
VGH	**Vision Group** healthcare conference	16-11-06
SIP	**Sigma** Healthcare conference	16-11-06
N/A	**MBF** Healthcare conference	16-11-06
SYB	**Symbion** Healthcare conference	16-11-06
PRY	**Primary Healthcare** Healthcare conference	16-11-06
RRA	**Radio Rentals Australia** IPO	20-11-06
HVN	**Harvey Norman** AGM	21-11-06
IPN	**Independent Practitioner Network** AGM	22-11-06
RHC	**Ramsay Healthcare** AGM	22-11-06
KYC	**Keycorp** AGM	23-11-06
CAB	**Cabcharge** AGM	23-11-06
WOW	**Woolworths** AGM	24-11-06
KIL	**KFM Diversified Infrastructure & Logistics Fund** IPO	27-11-06
FXL	**FlexiGroup** IPO	28-11-06
SIP	**Sigma** site visit	29-11-06
PXS	**Pharmaxis** Healthcare Conference	29-11-06
VGH	**Vision Group** Eye Institute site visit	30-11-06

December

TEN	**TEN Network** AGM	6-12-06
RRA	**Radio Rentals** Site visit	7-12-06

SELECTOR Funds Management

FUND REPORT as at 31 December 2006

Issued by Selector Funds Management Limited ABN 85 102 756 347, AFSL 225 316. The investment information in this Fund report is historical and refers to the period to 31 December 2006. **Past performance is not an indicator of future performance** for this fund.

PERFORMANCE SUMMARY

	3 months (%)	6 months (%)	1 Year (%)	Compound Annual Return 2 Year (%)	Compound Annual Return Inception[1]
Total	**16.32**	**19.28**	**37.73**	**36.67**	**36.48**
Income	-	-	2.54	1.95	1.87
Growth	16.32	19.28	35.19	34.72	34.61
S&P/ ASX All Ordinaries Accumulation Index	**11.28**	**14.49**	**24.97**	**23.01**	**23.78**

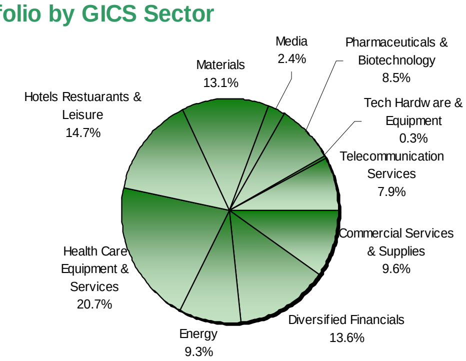
Returns are calculated on a using mid prices, and are calculated after all fees have been deducted with distributions included and no allowance made for tax. The 'income' component represents the amount paid by way of distribution, including net realised capital gains.

1. Inception date - 1 November 2004

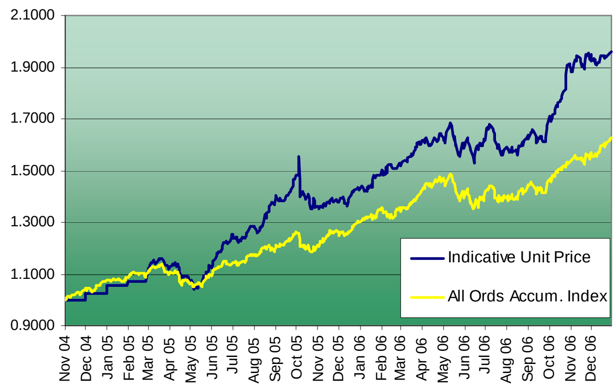
MONTHLY DETAIL (past 12 months)

Month ending	Mid Price	Distribution per Unit ($)	Month Gain (%) Fund	Inception Gain (%) Fund	Index Level	Month Gain (%) Index	Inception Gain (%) Index
31 Dec 06	$1.9027	-	0.46	95.82	34,334	3.62	62.59
30 Nov 06	$1.8939	-	2.45	94.94	33,136	2.48	56.91
31 Oct 06	$1.8486	-	13.02	90.41	32,335	4.80	53.12
30 Sep 06	$1.6357	-	3.32	69.12	30,853	1.25	46.10
31 Aug 06	$1.5831	-	3.07	63.86	30,472	3.18	44.30
31 Jul 06	$1.5360	-	-3.71	59.15	29,535	-1.51	39.86
30 Jun 06	$1.5951	0.0357	3.98	65.06	29,988	1.85	42.01
31 May 06	$1.5684	-	-2.96	62.39	29,442	-4.34	39.42
30 Apr 06	$1.6163	-	1.33	67.18	30,777	2.41	45.75
31 Mar 06	$1.5951	-	5.68	61.49	30,054	4.81	42.32
28 Feb 06	$1.5094	-	3.10	52.92	28,676	0.70	35.80
31 Jan 06	$1.4640	-	4.02	48.38	28,477	3.65	34.85
31 Dec 05	$1.4074	-	3.62	42.72	27,475	3.04	30.49

Portfolio by GICS Sector



Unit Price Movement vs Index Since Inception



To receive an Information Memorandum

Phone: 61 2 9241 5830, email **corey@selectorfund.com.au** or visit the website: **www.selectorfund.com.au**

Applications for units can only be made on the application form in the Information Memorandum (IM) dated 15 October 2004 and Supplementary Information Memorandum (SIM) dated 1 January 2006. Potential investors should consider the IM and SIM before deciding whether to invest in the Fund.

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