

FUND PERFORMANCE

Since its inception in November 2004 the Fund has delivered a net return of **69.12%** for the period to 30 September 2006 inclusive of **\$0.0555** cents in total distributions to unit holders, out performing the All Ordinaries Accumulation Index, which has risen by 46.10% over the same period. See table on page 8 for portfolio statistics since inception

BIG PICTURE

"Survival of the fittest"

It was an unlikely article in *Forbes* magazine (4 September 2006) that first got us thinking about "Survival of the fittest" in relation to our stock selection process and the evolution of the various businesses we hold.

"Flat as a pancake, lacking a tongue and having feet that face backwards"

The *Forbes* article by, Harvard Psychology Professor Steven Pinker describes a frog called *Xenopus* or "strangefoot" which has some rather odd features, most notably, being as flat as a pancake, lacking a tongue and having feet that face backwards. This frog madly flaps food into its mouth with its forelegs, which gives the impression of one clapping its hands.

Like "strangefoot" investor reaction to the annual reporting season just past was as odd as it was unpredictable. First up on our radar, Chris Roberts CEO of world leading bionic implant maker **Cochlear** posted a stellar full year result only to see the stock sold down 7% on the day. While some wanted more, Roberts's response to the knocked down share price was just as emphatic – he bought more stock and likewise, so did we.

Next, Peter Farrell CEO of sleep apnoea specialist **Resmed** delivered in spades. In similar fashion to **Cochlear**, **Resmed** was sold off aggressively, falling some 8% and again we helped ourselves and bought more. Even the *Australian Financial Review* (4 September 2006, page 15) picked up

on the group's rising star qualities - "**Resmed's** latest results show it may even be pulling away from **Respironics** and establishing itself as the number one global player in sleep".

On the flip side, **Paperlinx**, **Amcors** and even debt laden no hoper **Repcos** rallied. The latter, driven by market scuttlebutt that the same private equity team that gave us **Repcos** would now "take it back". Dick McIlwain, Chairman of rival **Super Cheap Auto Group** and newly appointed CEO of the merged gaming group **Tattersalls** (see separate story below) likened "this to a dog revisiting its vomit." McIlwain has always been on to speak his mind!

"Did anyone, other than debt hungry private equity players, ever seriously argue that the poorly designed should triumph?"

All this led us to question why the share market had mercy for the weak during the reporting season.

Did anyone, other than debt hungry private equity players, ever seriously argue that the poorly designed should triumph? Well, yes, quite a few people did. Charles Darwin (1809 – 1882) wasn't the first scientist to try to explain the passing of so many species. Many rival theories asserted that the fittest must perish.

There was for example, the theory of orthogenesis. It held that certain trends, once started, could not be stopped, even though they led to extinction through increasingly inferior design. For instance, Irish Elks had enormous antlers. It was held that they became extinct because they were unable to stop their growth. Likewise, the demise of the Sabre-tooth tiger can supposedly be traced back to their teeth, which grew ever longer, until the poor creatures could no longer open their jaws wide enough to use them.

It would seem that "Survival of the fittest" was not well accepted and only gained credence in later years.

“Survival of the fittest was coined by the British Economist Herbert Spenser”.

In fact the phrase “Survival of the fittest” was actually coined by the British Economist Herbert Spenser (1820–1903) and **not** the English Naturalist Charles Darwin who famously penned *Origin of the Species* in 1859.

During his five-year stint as sub editor of the London financial paper *The Economist*, Herbert Spenser produced works concerning education, science, the railway industry, population explosion and many other philosophical and sociological topics.

Spenser actually began using the phrase after reading Darwin's *Origin of Species*. He introduced it in his *Principles of Biology* of 1864, vol. 1, p. 444, writing "This survival of the fittest, which I have here sought to express in mechanical terms, is that which Mr. Darwin has called 'natural selection', or the preservation of favoured races in the struggle for life."

“Companies which offer better goods and services survive better in the market place and tend to accumulate an ever-growing market share in the long term”

In *The Man Versus the State* of 1884 Spenser penned this phrase to reinforce his economic theories. His basic premise noted that companies which offer better goods and services survive

better in the market place and tend to accumulate an ever-growing market share in the long term. Poorly-adapting companies are eventually forced out by better-adapting ones, or simply put, “killed” off by competition.

You could be forgiven for thinking that this theory had been written with **Cochlear, Resmed, Repco** and the June 2006 reporting season in mind, rather than 122 years ago. And to think today we denote 3 – 5 years as long term!

Equally, it can be applied to *Xenopus* or “strangefoot”, neatly explaining the benefits that were adapted over time. These frogs lived under water. Over time they lost their sticky tongue (useless in water), modified the use of their hands to catch prey and reshaped their feet and body for streamlined swimming. Its silly appearance is the product of re-tooling.

“This simple fundamental premise applied to evolution and economics over centuries is equally relevant to stock selection”

It strikes us that this simple fundamental premise applied to evolution and economics centuries ago is equally relevant to stock selection. In fact the combinations of the 20 elements that make up the “Selector Roadmap” are designed to seek business qualities that enable “Survival of the fittest”. While the 20 individual segments making up our company “Roadmap” are all essential in ensuring business survival and corporate fitness, investors often overlook the two highlighted centre boxes. We see them as particularly important to long term survival and financial success.

The first is all about re-tooling. This is essential if a business has any hope of delivering on the second in a sustained manner.

Locally, supermarket leader **Woolworths** is perhaps the best example of success in these endeavours through the group’s hugely successful “Project Refresh” transformation initiatives. Chief architect and recently retired CEO Roger Corbett commented, “We’ve restructured the systems, we’ve restructured the distribution, and we’ve restructured how the company is managed”. Such an ongoing focus on the back end systems of the business has seen the group’s supply chain evolve to become internationally “best of breed” and the retail benchmark others aspire to. Amazingly, it is often forgotten that this business evolved from “a toad” that was in the hands of receivers some fourteen years earlier.

Selector Roadmap

Qualitative			Quantitative		
Management Qualities	Owner Qualities	Focus	Growth	Business Qualities	Balance Sheet
Individuals we can trust 0 or 1	Material equity holding in the business 0 or 1	Monopoly/ Duopoly Niche or franchise 0 or 1	Reinvesting in the business 0 or 1	Businesses that we can understand 0 or 1	Low debt levels 0 or 1
Drive to take the business forward 0 or 1	Share a common bond with ordinary shareholders 0 or 1	Adapt to business conditions 0 or 1	Drive & resources to deliver real EPS growth 0 or 1	Well positioned in chosen industry 0 or 1	Simple structure 0 or 1
Clear articulation and consistency of business strategy 0 or 1	Track record 0 or 1	Do not succumb to share market pressure 0 or 1	Free cash flow 0 or 1	Strong or improving ROE 0 or 1 ROCE 0 or 1 ROA 0 or 1	Manageable Cap Ex 0 or 1

In contrast, telecommunication incumbent **Telstra** finds itself at the other end of the spectrum having just started the transformation process from “old world” legacy business structures to new, openly competitive income streams. Here again, it is all about simplification – the process of removing redundant systems (and regulations) that are working to hinder the group’s progress.

“The founder of Toyoda Spinning and Weaving Company, dreamed of providing cars for the general public”

The process of business evolution and re-tooling was first championed by **Toyota** in Japan. At the end of World War II, Sakichi Toyoda, founder of Toyoda Spinning and Weaving Company,

dreamed of providing cars for the general public, much like Henry Ford’s dream thirty years earlier. He employed Taiichi Ohno to put in place an efficient production system to produce high quality automobiles. Over the next three decades, Ohno developed the Toyota Production System, now referred worldwide as “Lean Manufacturing”. Importantly, Ohno’s philosophy was founded on the absolute elimination of waste.

Ohno studied US manufacturing techniques, and learned from Henry Ford’s pioneering work in assembly line flow. However, the Ford assembly line produced large lots of identical cars. Unfortunately, Ohno lacked the customer base to imitate the US practice of manufacturing in large ‘economic’ lot sizes. He was however, captivated by the US supermarket inventory process - where a small quantity of every product, placed

on shelves and subsequently removed by shoppers were rapidly replenished. He decided to place inventory 'supermarkets' throughout his plant, and found that this technique dramatically lowered the 'waste' of in-process inventory. He named these inventory supermarkets "kanban".

Since Ohno was converting a spinning and weaving company into an automobile manufacturer, he already knew how to avoid building inferior product. Founder Toyoda Sakichi had invented an automatic shut-off mechanism that stopped a weaving machine the minute a flaw, such as a broken thread was detected. Ohno moved this concept to car manufacturing, where he insisted that each part be examined immediately after it was processed, and the line stopped immediately if a defect was found.

To maximize product flow, standard work sheets were created, but engineers did not develop these at a desk. They were developed on the shop floor by the workers who knew the process. Standard cycle times and "kanban" shelf space for each item was determined and workflow was levelled. Production workers were like a relay team, handing off the baton (product) to the next person. The handoff required 100% quality and tight timing. During delays, teammates were expected to help others set up machines to recover from a malfunction.

"Lean Manufacturing has been adapted to logistics, customer service, health care, finance, and even construction"

Ohno's aggressive elimination of waste led him to the twin values of rapid product flow and built-in quality. Over time, Ohno discovered that these two values led to the highest quality, lowest cost, and shortest lead-time products possible.

The basic practices of "Lean Manufacturing" can be summed up in ten simple rules:

1. Eliminate Waste
2. Minimize Inventory

3. Maximize Flow
4. Pull From Demand
5. Empower Workers
6. Meet Customer Requirements
7. Do it Right the First Time
8. Abolish Local Optimisation
9. Partner With Suppliers
10. Create a Culture of Continuous Improvement

These "Lean Manufacturing" rules have been tested and refined over the last two decades. Just as Herbert Spenser applied "Survival of the fittest" theory to both business and biology "Lean Manufacturing" has been adapted to logistics, customer service, healthcare, finance, and even construction. The application of these rules change slightly from one industry to the next, but the underlying principles have stood the test of time in many sectors of the economy.

"Adapt to business conditions...or you better pray for a private equity player and they might just become extinct!"

We first became aware of "Lean Manufacturing" during manufacturing site tours of **Resmed** and **Cochlear** in June this year. Both are implementing these practices. It is an evolutionary process of continuous improvement, which is designed to remove the craft element from the manufacturing process.

The real benefits of business evolution take time to shine through. That said the fourteen-year evolution of **Woolworths** seems to have been a blink.

Telstra have set an ambitious target of a 5-year transition. Some analysts are concerned it might take 6 years to deliver. After watching the three Amigo's rollout the 850 Mega Hertz 3 G network with no fuss and in world record time we reckon we have other things to worry about!

A further example arrived in the form of the 2006 **Publishing and Broadcasting Limited** Annual report that just landed on our desk. The obituary on Kerry Packer AC is a great read.

Kerry and his family understood the need to more than evolve 3 decades ago.

"When Kerry eventually became chairman and managing director in 1974, the company was undergoing a major transformation... In that year profits were \$3.2 million. They jumped sevenfold to hit \$23.4 million by 1982"

This year normalised net profit was \$611.5 million. Today, as we write, all national newspapers have headlines screaming about the transformation and evolution under James Packer as he sells 50% of the media assets for a reported \$4.5 billion to whom else but private equity.

With road map in hand, a key underlying strength we seek from every company is management's ability to "adapt to business conditions".

Without this ability to adapt and evolve you better pray for a "private equity player" and the way they are behaving they might just become extinct themselves!

An HOUR WITH DICK McILWAIN CEO Tattersalls Limited

Yes, yes, we have written about our meetings with Dick McIlwain previously and some readers may think our newsletter is repetitive... but that's exactly the point! We have a repetitive investment process and we use the roadmap to promote consistency.

McIlwain is a pretty simple bloke, who is not afraid to tell it as it is (*refer to paragraph 6 above for example*). He likes businesses that don't have too many moving parts.

It is from candid meetings like these that we

always walk away with renewed affirmation of the value and importance of getting to know management. Understanding management and their thinking represents the first six boxes on our roadmap (*laid out above*), and if your investing without this knowledge you are at a distinct disadvantage to those consistently doing this type of homework.

"Greedy culture that celebrates a man that has been dead for 100 years"

We were fortunate enough to be in Brisbane on the day the **Tattersalls** merger with **Unitab** was finally approved by the courts. It was also the last day that **Unitab** traded as a stand-alone entity on the exchange (28th of September 2006 – for interested history buffs).

So how many of the old **Unitab** guard would be moving to Melbourne to help McIlwain through the important first 100 days? Simple answer is none. McIlwain will go down and clean out the "greedy culture that celebrates a man that has been dead for 100 years". And greed doesn't just go to the top - it starts there. They say a fish rots from the head.

Over the years, outgoing CEO Duncan Fisher has helped himself to a fair slab of the treasury stock management were allotted under the will of George Adams. And to make matters worse, the Trustees are still pursuing an additional \$100M payout, also under terms of the will. No wonder they all celebrate his passing!

"Tattersalls is a 100 year old business that is set to undergo 100 years of evolution in the next 6 –12 months"

Tattersalls remains a great business franchise that could not be killed by management and that was what ultimately attracted McIlwain. Make no bones about it; **Tattersalls** is a hundred year old business that is set to undergo one hundred years of evolution in the next 6 –12 months under McIlwain.

The fact that McIlwain will turn up to his first day at work in Melbourne, entourage free, probably sheds some light on the changes to come at **Tattersalls** - a rebirth driven by simplification.

So what were the thoughts of the new man on his first day on the job?

Firstly, McIlwain noted that both **Unitab** and **Tattersalls** were simple businesses, with few moving parts, that largely shared the same customer type and the same regulatory environment.

Secondly, and central to the theme of evolution, wagering, gaming and lotteries are driven by technology and technology means less people... a lot less according to McIlwain, helped by the fact that already many are falling on their swords at **Tattersalls**. Importantly a technology driven business should deliver "revenue rotation".

This brings us to point three - an explanation of "revenue rotation" which was new to us also!

McIlwain said he would not want to be in a business driven by technology where the bottom line could not grow at least 1.5 times the revenue line. And in his view this is both the problem and opportunity presented by the **Tattersalls** business.

"The ability to evolve from a fat greedy culture into a streamlined technology house is a big bonus"

For McIlwain priority number one is extracting synergies out of the merger. Technology improvements, staff numbers and contract renegotiations will play a big role in their delivery. These factors will facilitate the necessary "revenue rotation".

Priority number two, much further down the track, is new revenue opportunities ... or maybe a break up of **Tabcorp** lead by a debt free **Publishing and Broadcasting Limited**? We'll leave that story for another day but if you think that's a bit too far fetched, it wasn't that long

ago that making an investment in **Tattersalls** felt like a very lonely place.

A duopoly business that is debt free and produces a lot of cash is likely to pay increasing dividends. The ability to evolve from a fat (overstaffed) greedy culture into a streamlined technology house is a big bonus. And when it is run by a past master with a very simple philosophy, we know we are on a winner.

READER FEEDBACK

We enjoy writing our newsletters and actively encourage feedback from our clients and wider readership base. Drop in for a visit or call Tony or Corey on 612 9241 5830.

The best compliment we can get is a referral so please share this newsletter with a relative or friend. This and past newsletters and up to date unit prices are found at www.selectorfund.com.au

COMPANIES VISITED DURING THE 1st QUARTER 2006-2007

July

KYC	Keycorp <i>Site Visit</i>	11-07-06
RIN	Rinker <i>AGM</i>	18-07-06
Unlisted	Mundo Minerals	24-07-06
GAA	Genepharma	31-07-06

August

PRY	Primary Healthcare <i>Results Briefing</i>	08-08-06
REF	Reverse Corp <i>Results Briefing</i>	09-08-06
TLS	Telstra <i>Results Briefing</i>	10-08-06
SAI	SAI <i>Results Briefing</i>	10-08-06
API	API <i>Results Briefing</i>	14-08-06
COH	Cochlear <i>Results Briefing</i>	15-08-06
ASX	ASX <i>Results Briefing</i>	17-08-06
PPT	Perpetual <i>Results Briefing</i>	17-08-06
IFM	Infomedia <i>Results Briefing</i>	24-08-06
RMD	Resmed <i>Results Briefing</i>	18-08-06
ALL	Aristocrat <i>Results Briefing</i>	22-08-06
OSH	Oil Search <i>Results Briefing</i>	22-08-06
WOW	Woolworths <i>Management Meeting</i>	24-08-06
BNB	Babcock & Brown <i>Results Briefing</i>	24-08-06
BNB	Babcock & Brown <i>Management Meeting</i>	25-08-06
TAH	Tabcorp <i>Management Meeting</i>	25-08-06
RHC	Ramsay Health Care <i>Results Briefing</i>	28-08-06
CEU	Connect East Group <i>Results Briefing</i>	28-08-06
AVV	AAV <i>Results Briefing</i>	28-08-06
CAB	Cabcharge <i>Results Briefing</i>	31-08-06
VGH	Vision Group <i>Results Briefing</i>	31-08-06

September

GPG	Guinness Peat <i>Management Meeting</i>	01-09-06
TTS	Tattersalls <i>Results Briefing</i>	04-09-06
FLT	Flight Centre <i>Results Meeting</i>	04-09-06
RMD	Resmed <i>Management Meeting</i>	07-09-06
HVN	Harvey Norman <i>Results Briefing</i>	11-09-06
SIP	Sigma Pharmaceutical <i>Results Briefing</i>	12-09-06
AUW	Australian Wealth Mgt <i>Management Meeting</i>	13-09-06
MWM	Mariner Wealth Management <i>Site Visit</i>	13-09-06
WES	Wesfarmers <i>Management Meeting</i>	21-09-06
TTS	Unitab / Tattersalls <i>Site Visit</i>	27-09-06
FLT	Flight Centre <i>Site Visit</i>	27-09-06
REF	Reverse Corp <i>Site Visit</i>	27-09-06
DBS	Dark Blue Sea <i>Site Visit</i>	28-09-06