

## FUND PERFORMANCE

Since its inception in November 2004 the Fund has delivered a net return of 65.06% for the period to 30 June 2006, out performing the All Ordinaries Accumulation Index, which has risen by 42.01% over the same period. This return is inclusive of a \$0.0357 cents per unit distribution in respect of the previous 12 months (to be distributed). The twelve month return of the Fund was 31.96%. See table on page 8 for monthly performance since inception. **SFM**

## BIG PICTURE

The big picture today is undoubtedly the China, India "super cycle" story with a "sliding greenback" (US dollar) thrown in for good measure. These topics have taken the popular press by storm and have now usurped "global warming", "the Internet" and "WMD's" as hot topic dinner party debates.

During the quarter we even attended a presentation where the investor relations director of an ASX 300 company explained the opportunities for his company in "Chindia". For those of us not versed in such "lingo" that's China and India put together. Presumably the take away (*for the uneducated masses*) is that the opportunities are so bountiful that you need to say it in one breath!

***"Trusting a demographer is like basing an investment decision on a stockbrokers report"***

So at the suggestion of a new client (thanks John) we turned to population demographics, to try and make some sense of the big picture. Be warned however, trusting a demographer is like basing an investment decision on a stockbrokers report. (***See newsletter 31 March 2006***). That said, we have drawn our statistics from the *United Nations World Population Prospects: The 2004 Revision*, *The World Bank*, *The Economist*, *Eurostat* and several speeches on demography by Malcolm Turnbull MP as well as various population websites dished up by Google.

As a starting point, a good demographic rule of thumb to remember is that a stable population with a birth rate of 1.3 (children per woman) loses 1.5% of its population each year and within a century will reduce in size by 75%.

In Europe today, these circumstances are unfolding for a great many nations. If today's current birth rates continue, in 100 years time, the descendants of the current inhabitants of Italy, Spain and Greece will number roughly 23% of their present day numbers.

At a social level, if Europe maintains its low birth rates its character will be quite unrecognisable within a hundred years, which in the sweep of history is barely a blink of the eye. The economic consequences however are even bleaker.

As the World Bank argues in *"The third Transition"* old populations are a handbrake on economic growth. No surprises here, since with fewer workers contributing to productivity and an ageing population more reliant on care, the knock on effect for governments footing an ever mounting healthcare and pension bill looms large on the horizon.

These economic consequences stem from the generational pressures of a shrinking tax base and compounded by the strong welfare cultures that dominate Europe. Many of these pension and health schemes are unfunded and are paid for out of current taxes placing enormous pressure upon future generations to bridge the funding gap.

***"Europe would require an invasion of massive proportions"***

Under these circumstances immigration is often touted as the answer. While immigration can theoretically dig countries out of a fertility drought, from a practical point of view, Europe would require an invasion of massive proportion. And while Australia's multicultural mix may add weight to debates supporting greater assimilation, immigration is proving to be a major source of destabilisation in Europe. Each year some 900,000 migrants find their way to Europe, mostly from Muslim countries.

On June 24<sup>th</sup> 2006, The Economist ran with a cover story titled "Eurabia" – today 4% of the European Union inhabitants are Muslim, or a total of 20 Million. By 2050, Europe's Muslim population is expected to increase to nearly 20% and close on 50% in France. We also note that Turkey's inclusion in the EU would have seen today's figure soar closer to 17%. In general, Muslim countries enjoy birth rates that are amongst the highest in the world, including the likes of Pakistan 5.1; Saudi Arabia 4.5; Libya 3.5; Egypt 3.3; and Morocco 3.0 (births per woman). As the statistics reveal, Pakistan is a standout on the fertility front and a country we expect hear more about in the future.

***"Amongst the fertility gloom, Europe's one major bright spot is Ireland"***

Destabilisation occurs when marginalisation of a population is either real or perceived. In France, political participation within the Muslim community is very low. For instance, while 97% of French adults are registered to vote only 37% of the Muslim population is registered. Low representation and high unemployment equals social tension. When rioting and affray are commonplace, as in France, extreme elements are more likely to gain a foothold with the aim of working to encourage youths into acts of terrorism.

Amongst the fertility gloom, Europe's one major bright spot is Ireland. According to Eurostat, Ireland enjoys the triple whammy, recording the strongest real GDP growth in Europe, the youngest population and the highest population growth to boot. These solid economic indicators coupled with a very attractive tax regime have enticed many Irish expatriates back to the motherland. And judging by **Babcock & Brown Capital's (BCM)** current full bid for Ireland's national telecommunications carrier Eircom, Ireland's attractive business conditions have not gone unnoticed.

Leaving the EU behind, what can we make of the pre "Chindia" super powers, the United States (US) and Russia. Do they still have a role to play on the global stage?

***"The North America population will increase some 43% ... to in excess of 500 million by 2050"***

In contrast to the Europeans slow decline, the demography score board for the US points to future prosperity and a continued position of global strength.

On this point, the United Nations report certainly got our attention, forecasting that the North American population will increase some 43% from circa 331 million in 2005 to in excess of 500 million by 2050. Put another way, by 2050 the US population could surpass that of the European Union. Maybe in time, the US can also find a way to increase national savings, reduce debt and limit the greenback's demise.

And while European governments labour under a rising social security impost, America's more liberal self funding retirement programs provide it with a distinct competitive edge. According to Malcolm Turnbull MP, *The Economist* has predicted that by the middle of this century, the median age of an American citizen will be 36 years compared to their European counterparts at 58 years of age and with this comes an accompanying drop in generational social security pressure.

Furthermore the US's immigration numbers are big. Projected at over one million annually it tops the list of all other nations and reflects in part, America's improved tolerance towards cultural assimilation. Importantly in the US it is easy for a new comer to get work but hard to get social security, whereas in Europe the opposite is true.

***"It's not hard to understand why Russia will never regain its former importance..."***

The same cannot be said of former super power, Russia, which continues to reel from the dramatic collapse in its national birth rate. It's not hard to understand why Russia will never regain its former importance when you consider that by the middle of this century, its population will number less than one quarter of its traditional rival the US, based on today's birth

rate statistics.

So how do we fair at home? Actually quite well, considering that Australia's population level over the same period is forecast to grow by one third to 28 million. By 2050 Australians in the workforce (defined as 15-59 years of age) are expected to decline from 63% to 54%. However, in absolute terms, workforce numbers are expected to have climbed some fourteen per cent while Australia's strengthening savings culture and strong fiscal position should see it well placed to compete against fellow developed nations.

When it comes to our key trading partners, both Japan and Korea are no less immune to the forces of nature. A low birth rate with little or no replacement immigration policy in place is further compounded by inadequate self retirement options and health care funding strains. In Japan's case, its population is forecast to decline by 17 million over the next 45 years while its workforce will drop by an even greater 30 million. The future may well see these two important trade partners struggle with the onset of a greying population.

***"China has a non-existent welfare system"***

All this brings us back to the twin super cycle drivers "Chindia". In a global population numbering some 6.5 billion inhabitants, the sheer numbers making up China and India set them apart from the pack.

For its part, China at 20% of global numbers or 1.3 billion is a special case. Because of the one child policy its birth rate is low by developing country standards at 1.8 (births per woman). While an ageing population may expose China to problems long term, to date it appears less of a concern for a number of reasons.

Firstly, China has a non-existent welfare system and while it will encounter a growing percentage of dependent aged in the future – expectations that government will provide adequate financial handouts remain low.

Secondly, China's economic growth is driven by its ability to shift workers from subsistence

farming to productive work. As long as there remains an untapped labour force whose productivity can be upgraded, the likelihood of China continuing its strong run of economic growth appears well founded.

Thirdly, China has no immigration issues, as there is none to speak of.

China's speed bumps are more likely to stem from politically sensitive issues of autonomy from the state, human rights and the uneven distribution of wealth that inevitably comes with newfound prosperity. Not to mention satisfying its own enormous appetite for natural resources and the need to maintain sustainable long term growth.

***"Nothing can sap the momentum unleashed 15 years ago"***

And since India already represents close to 15% of the world's population, it is worth drawing breath to consider them separately.

India's economic reform was initiated some fifteen years ago. Today, these reforms see India positioned on a strong trajectory path. Their numbers will continue to grow from around 1 billion to 1.5 billion by 2050. And while its current fertility rate of 3.0 (births per woman) is expected to drop below two, workforce numbers are set to rise.

According to *The Economist* (June 3<sup>rd</sup> 2006 Edition Titled: *Can India Fly*), India's GDP has averaged a robust 8% rate of growth over the past three years. Better still, this figure is expected to ramp up, especially if India is to cash in on its "demographic dividend". With a youthful population as its backdrop, India will add an extra 71 million people to its workforce over the next 5 years, or nearly one quarter of the world's additional new workers. And with such profound changes under way *The Economist* adds "Demography will help raise the level of private savings from 29% to 35% of GDP over the next five to seven years. Investment will follow, so GDP will continue to grow at 8%, even if reforms stall. Nothing can sap the momentum unleashed 15 years ago."

***"GDP = Productivity x Participation x Population"***

So in summary the global top five by demography 50 years down the track goes something like this... India first, followed by China, Pakistan (the bolter), the US and Indonesia. Of this group we believe both Pakistan and Indonesia in future years will make their presence felt to a much greater degree than is currently the case.

Furthermore, if we accept the general premise that - *GDP equals Productivity multiplied by Participation multiplied by Population* - we start to understand the double whammy economic impact that a falling and ageing population can cause.

***"demographics can support the "Chindia" story"***

So it seems that demographics can support the "Chindia" story, though we have made our position on the reliability of such forecasting relatively clear.

From the statistics presented, Australia appears relatively well positioned in the context of developed nations. It will however, be increasingly interesting to monitor how our political leaders in coming years, handle our gargantuan neighbour to our north.

For us, the real surprise player in all of this is the US. They enjoy solid population growth, an ongoing high participation rate due to the relatively young median age of its people and reasonable prospects for immigration. Overall the US appears much better placed than the ageing European Union. **SFM**

## **THE 2005-2006 YEAR IN REVIEW**

Undoubtedly the themes that dominated financial headlines during the course of 2006 included surging commodity prices, mega merger deals and the growing debate regarding global interest rates and inflation. For our part it was business as usual. While volatility in financial markets took centre stage in the latter months, it is

neither new, nor does it come as a surprise. To the contrary, we relish the opportunities that such periods generate. In the following paragraphs we have focused on some of the events that made up our year.

We visited, met with or attended presentations by some 180 listed companies during the 2005 – 2006 financial year. In addition we would have passed on at least this many again, that did not meet our investment criteria.

With this as a back drop, we culled the field further, resulting in an ongoing detailed research focus on around 50 companies from which a core investment portfolio of 16 businesses now forms the basis of the Fund. Of these 16 core holdings, we averaged five visits per company during the past year. For us, this process is essential as it allows us to add a new chapter to the book of each and every business on each and every visit.

Importantly these visits provide us with unique insights, allowing us to generate a roadmap and a company report that are compared to previous roadmaps and reports in order to identify any inconsistencies or change. It's a simple process that is easy to repeat and it digs a little deeper and adds a little more value on each occasion. In doing so, the process is designed to temper any decision-making made on the run.

Lining up on the resources front, **Kagara Zinc Limited (KZL)** (*Refer newsletter # 3, 31 March 2004*) was undoubtedly a major beneficiary of its unhedged exposure to the strong zinc price rally. Falling LME stockpile inventory levels and the lack of new mining developments anytime soon, underpinned the metal's strong fundamentals. But even more importantly, **KZL** backed up its earlier successful exploration program with several resource upgrades driven by stellar drilling results in the field. Backed by a straight shooting and trust worthy management team, we expect further upgrades across a variety of commodity types including gold. The move from explorer to production status and the strong cash flows now evident are not only a sign of a business maturing but likely to lead to the payment of the group's maiden dividend during 2007.

**Petsec Energy Limited (PSA)** (Refer newsletter # 2, 31 December 2003) stayed the course and similarly benefited from strong natural gas prices in the United States. More recently oil discoveries in the US Gulf of Mexico and the Beibu basin in China with fellow partner and operator **Roc Oil (ROC)** (Refer newsletter #10, 31 December 2005) have generated considerable interest. Follow up development work needs to be done to determine the potential economic benefits that are likely to flow from these exciting discoveries. While acknowledging that success does not come without considerable risks, we are more than comforted by the seasoned management teams at the helm. As we write, two days before the quarter closes, **ROC** has undertaken an acquisition of a producing petroleum field in China. This will have a "profound impact on the company" according to **ROC's** MD Dr John Doran – and he is one manager you can trust.

On the corporate front, mergers and acquisitions were all the rage and included our very own Australian based bionic ear implant manufacturer **Cochlear Limited (COH)** (Refer newsletter #2, #4, #9, #10) acquiring Swedish based hearing maker Entific Medical Systems. Highly complimentary, Entific's product offering significantly expands **COH's** product diversity using an existing worldwide sales footprint, undertaken by a similar global network of surgeons in existing hearing clinics. Superior product reliability helped **COH** cement its worldwide market dominance as competitors stumbled with product recalls and growing patient unease.

True to their word, management at **SAI Global Limited (SAI)** (Refer newsletter # 2, 31 December 2003) made several bolt on acquisitions during the period. More recently the group completed its largest to date, forking out \$70M for UK based standards publishing and database services group ILI. This purchase firmly established **SAI** as a global player in standards publishing and forms a central plank in the group's stated growth strategy.

Last issue we made mention of the "merger of equals" tie up between **Unitab Limited (UTB)** and **Tattersalls Limited (TTS)**. Complicating matters further has been **Tabcorp's (TAH)** own

recent offer for **UTB**, which has now opened up the potential for a bidding war. For the moment though, we see little chance that **TAH** could successfully persuade the ACCC to pass this one through. That said, Graeme Samuel and the team at the ACCC are answerable to no one and have a record of approving the unexpected.

In March of this year, listed property management services company **S8 Limited (SEL)** embarked on an aggressive consolidation of the travel industry sector in both Australia and New Zealand, culminating in the takeover of **Transonic Travel Limited (TNS)**. A core holding, **TNS** represented roughly 3.5% of our portfolio with an average entry price of \$2.90. The Fund exited the position in May, bagging \$5.00 cash per share.

Why did we sell? We would rather not take on the inherent integration risks that **SEL's** five "rapid fire" acquisitions now need to navigate. All our investments are made on the basis that we trust management and have faith in their capabilities amongst other factors of course. **SEL** management were an unknown quantity for us, entering a new non-core industry at break neck speed in order to bulk up enough to join the ASX 200 index. The requirement for blind faith did not sit comfortably with us even though many brokers rushed to initiate coverage with buy recommendations.

In early June **Select Managed Funds (SEM)** (Refer newsletter # 9, 30 September 2005) completed its merger with **Australian Wealth Management (AUW)**. This is one we added to in the recent period of weakness. In contrast to **SEL**, the same management team has been retained, under the **AUW** banner, in a virtual backdoor takeover that has added scale and will deliver synergies. This is a management team we have confidence in. It is also a team that has walked away from significant acquisitions in the past because the integration has been viewed as being too complex.

As to the year ahead, we suspect that conditions are unlikely to be as kind to market participants as the recent past. While the "rising tide lifts all boats" has certainly been a common theme of late, we sense a sea change (*excuse the pun*).

Specifically, individual stock picking will enjoy a welcome return to form. Those companies that are well positioned and able to deliver will do well, while a fair few are likely to disappoint. Under these circumstances, we have every confidence that our investment style can prosper.

Looking specifically to the year ahead, the re-emergence of the telecommunications sector is one that is likely to gain considerable traction. We are not alone in our thinking, a number of private equity players are busy planting their own 'stakes in the ground'.

Take for instance **Babcock & Brown's (BNB)** (Refer newsletter # 8, 30 June 2005) full takeover offer for Ireland's incumbent telecommunications operator Eircom. Along with **BNB**, the \$8Bn dollar bidding consortium also includes the listed cash box **BCM** as well as Eircom's own internal Employees Shareholders Pension Fund. From a demographics perspective (see cover story), Ireland is certainly one of the most attractive economies in the EU and **BNB** have recognised this point. As to their game plan, **BNB** appears open to the opportunity of splitting the telco operator into two separate parts forming a consumer business and a regulated infrastructure business. The eventual sale of one and the retention and likely share market re-rating of the other is expected to unlock considerable inherent value.

At a recent Eircom briefing we asked a **BNB** executive that if circumstances allowed, would **BNB** have interest in acquiring **Telstra (TLS)**? Hypothetical as this may sound, **BNB** were not dismissive of the possibilities. While it is highly unlikely that any Federal Government would ever allow the telecommunication circumstances of Ireland to unfold here, we expect the upcoming government sale of the remaining Telstra shares to generate considerable investor interest.

Not to be outdone, **Macquarie Bank (MBL)** has also seen merit in entering the telecommunication space, publicly disclosing an interest in bidding for PCCW - Hong Kong's fully integrated national telecommunications carrier in concert with other like minded venture capital investors. We now understand that Rupert

Murdoch has held preliminary talks with **MBL** in relation to PCCW. We are certain to hear more on this in the coming months.

And when it comes to our very own **TLS** (Refer newsletter # 1, 30 September 2003), the proposed rollout of a new fibre to the node network (FTTN) in the near term is sure to generate significant interest for some and heartache for others. While the market has priced in a worst case scenario for our national carrier, all is not lost. To the contrary, we believe that the second tier carriers from **Optus** down may have more to worry about, than **TLS**, in the year ahead. Chairman of the ACCC Graham Samuel recently warned (**AFR 23 June 2006**) that some competitors would have their investment in DSL "stranded" by **TLS's** proposed new faster network.

In closing the 2005-2006 financial year, and our 12<sup>th</sup> quarterly newsletter, we would like to thank you, our investors, for your continuing support. Furthermore we hope that you take advantage of our open door policy, which actively encourages contact either in person or by phone. We appreciate your feedback throughout the year and look forward to the year ahead. **SFM**

**COMPANIES VISITED DURING THE LAST QUARTER:**

April		May		June	
MFI	Mariner Financial	ALL	Aristocrat AGM	NCM	Newcrest Mining Conference
SDM	Sedgeman IPO	COH	Cochlear Conference	Unlisted	Lime Taxi's CEO Presentation
PSA	Petsec Energy visit	FXJ	Fairfax Conference	VGH	Vision Group CEO Briefing
DDT	Datadot site visit	GPT	GPT Conference	HTA	Hutchison Telecom CFO Presentation
AAV	AAV Conference	HSP	Healthscope Conference	ROC	Roc Oil CEO Briefing
ABS	ABC Learning Conference	JBH	JB-HiFi Conference	BCM	Babcock & Brown Capital CEO Presentation
ALS	Alesco Conference	MCG	Macquarie Communications Conference	RMD	Resmed Site Manufacturing Tour
BEI	Babcock & Brown Environmental Conference	MIG	Macquarie Infrastructure Conference	COH	Cochlear Site Manufacturing Tour
AUB	Austbrokers Conference	MFS	MFS Conference	RHC	Ramsay Site Hospital Tour
FZN	Fone Zone Conference	OSH	Oil Search Conference	SYB	Symbion Site Hospital Tour
CRG	Crane Group Conference	QBE	QBE Insurance Conference	EBB	Everest Capital CEO Presentation
Unlisted	Link Market Services Conference	RHC	Ramsay Healthcare Conference	AWC	Alumina Conference
MOC	Mortgage Choice	RMD	Resmed Results Briefing	OXR	Oxiana Conference
PGA	Photon Conference	SAI	SAI Global Conference	ABY	Aditya Birla Minerals Conference
SEL	S8 Conference	SLM	Salmat Conference	GCL	Gloucester Coal Conference
SEM	Select Managed Funds Conference	SEK	Seek Conference	PDN	Paladin Resources Conference
TPI	Transpacific Conference	SUL	Super Cheap Conference	WPL	Woodside Petroleum Conference
		TTS	Tattersalls Conference	STO	Santos Conference
		TLS	Telstra Conference	HDR	Hardman Conference
		TOL	Toll Holdings Conference	AWE	Australian Worldwide Exploration Conference
		WOW	Woolworths Conference	ROC	ROC Oil Conference
		WTF	Wotif Conference	OSH	Oil Search Conference
		ZFX	Zinifex Conference	GAA	Geneparm Australasia Management Meeting
		OLX	Oilex CEO briefing	MBL	Macquarie Bank Conference
		PSA	Petsec Energy AGM	RCD	Allco Finance (Previously Record Inv) Conference
		SAI	SAI Global Briefing	BNB	Babcock & Brown Conference
		MBL	Macquarie Bank Results briefing	EMH	Emeco (IPO)
		KZL	Kagara Zinc Briefing	SRG	Sydney Roads Group (IPO)
		FLT	Flight Centre Site visit	AGL	AGL Conference
		OSH	Oil Search Briefing	JGL	Jack Green Conference
		BXP	Bill Express Management meeting	Unlisted	Tru Energy Conference
		BVA	Bravura IPO Presentation	Unlisted	Delta Electricity Conference
		BNB	Babcock & Brown AGM	AIHCA	Alinta Infrastructure Holdings Conference
		CIL	Centrebet IPO Presentation	AOE	Arrow Energy Conference
		CGF	Challenger Financial CEO Presentation	Unlisted	Epic Energy Conference
		IWL	IWL CEO Presentation	BBI	Babcock & Brown Infrastructure Conference
		TRG	Treasury Group CEO Presentation	ALN	Alinta Conference
		FPA	Fisher & Paykel Appliances Results Briefing	BBW	Babcock & Brown Wind Partners Conference
				SPN	SP Ausnet Conference
				SKICA	Spark Infrastructure Conference
				Unlisted	Babcock & Brown Power Generation Conference