

FUND PERFORMANCE

Since the inception of the Fund in November 2004 the Fund has delivered a net return of **61.49%** for the period to 31 March 2006, inclusive of a **\$0.0198** cent distribution to unit holders, outperforming the All Ordinaries Accumulation Index, which has risen by 42.32% over the same period. See table on page 7 for the Fund's monthly performance since inception.

SFM

BIG PICTURE

Beware the press or an analyst! Reasons why we prefer to go it alone.

Ever given some thought as to how professional analysts from the bigger broking houses so often reach such a tight consensus of views on a particular stock? How much are they persuaded by each other? Well, judging by the behaviour of a few that we observed at a recent analysts briefing for a top 100 company, pretty close would be an apt description.

While swapping family snaps from the Christmas break prior to the meeting is far from incriminating, breaking ranks with a contrarian view or a valuation that is out of step with the majority carries considerable risk to one's own pride, reputation and ability to on sell oneself to a higher paying broking firm.

"acting in concert with the masses is unlikely to result in investment out performance"

Now the power of persuasion is not a new concept and the media in particular are past masters of this art. But to keep this simple – do you remember standing in a line at school as a message was passed from one student to another? Generally the original message gets distorted beyond recognition, and if this "Chinese whisper" was passed to you by a close friend – it's more than likely you would have accepted it as gospel, no matter how distorted! And as kids, not many of us challenged group thinking. Consensus was a far safer bet.

We're not suggesting that broker research is

overrun with distorted concepts, or that analysts today mimic the actions of school kids. What we are suggesting is the need for more original and independent investment thinking. We believe that acting in concert with the masses is unlikely to result in investment out performance.

We recently noted a study where a large group of students were recruited for what they were told was market research, conducted by a company making high technology head phones. Each student was given a headset and told the company wanted to measure how well they worked when the listener was in motion, either, dancing up and down or shaking his or her head.

All the students listened to popular songs and then heard a radio bulletin arguing that university course fees should be raised from the present level.

"the depth of questions from professional analysts frustrates us"

A third of the students were told to nod their head vigorously up and down while listening. The next third were told to shake their head from side to side. The final third were the control group. They were told to keep their head still.

When they finished, all the students were given a questionnaire, asking them about the quality of the songs and the effects of shaking. Slipped in at the end was the real question. "Do you think university course fees are appropriate?"

The responses to this question provided the real surprise. The students who kept their head still were unmoved. Those who shook their head from side to side disagreed strongly with the proposed increase in fees. Those who were told to nod their head up and down found the bulletin very persuasive and were prepared to recommend a policy that resulted in an average fee increase of 18% paid directly out of their hip pocket.

"press... can be absolutely misleading"

Can we conclude from this that analysts who shake their head up and down think the market is going up and those that shake their head from side to side think it is going down? Probably not! But we can be a little more certain that the

power of persuasion is strong and that independent thinking can be hijacked.

Company releases are increasingly being delivered by way of phone hook ups and web casts, both live and recorded. While this is convenient, as a priority we attend in person when ever possible and for good reasons. For one, watching the body language of managers entrusted to run the business is worth more than the effort expelled in turning up, particularly when the session turns to question time. Secondly, forming an unbiased opinion, independent of broker reports or a newspaper story is critical to the view ultimately adopted.

More often than not, the depth of questions from professional analysts frustrates us. The main goal is to obtain numbers to plug into a model. Business managers are peppered with questions about the next quarter's growth rates, tax charges and depreciation changes – all for a DCF (discounted cash flow) modelled into the never-never. And then miraculously, a consensus is reached. The focus of this type of research is generally narrow, short term and of little or no value to a long-term investor, other than providing a buy opportunity if a market is sufficiently spooked.

“as well informed as a reader who starts a book in the middle”

Further along the “value” chain we find the financial press. An investor relying on today's constant stream of updates and breaking news is as well informed as a reader who starts a book in the middle. Media news flow encourages action rather than providing any insightful company analysis. It's often impossible to discern the facts let alone take a view other than that presented in print; you simply don't get the whole story. Yet the media hype influences the investing community daily.

Clearly a little bias goes a long way, just ask our “dancing students”. Too often analysts will produce a modelled output while totally disregarding the bigger picture. We just don't think a discounted cash flow model takes into account some important business features like management input, competitive edge or barriers to entry to name just a few on our “road map”. Each of the elements that make up our “road

map” can be uncovered by fronting up, digging around and thinking independently.

Independent thinking then, is a rare commodity. And our thoughts are;

- (a) This is not aided by the communication between competing analysts and their desire not to stray from consensus numbers.
- (b) That the power of persuasion, as proven by our “dancing students”, is alive and well, particularly in the press. And
- (c) The press is unlikely to be a reliable source of insightful or accurate analysis.

Not for a minute are we suggesting we “will shoot the lights out” with every investment. Rather we believe that we get paid for fronting up, digging around and thinking independently. And most importantly, it is independent thinking that can lead to investment out performance.

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MERGER OF EQUALS

Events currently unfolding include the “merger of equals” between **Unitab** and **Tattersall's**. A cute tag line, but perhaps a more apt description would depict an undervalued **Tattersall's** acquiring a more fully valued **Unitab**, where the prize for both sets of shareholders is delivered some years out.

Some in the media and the majority of analysts are gob smacked that the bid offers little or no premium to **Unitab** owners.

We on the other hand see merit in both the bid and the price being paid, noting that the longer term benefits likely to flow from the merged operations will more than make up for any short term screams of foul play.

And to that end, **Telstra** may well turn out to be another example of consensus thinking gone wrong. SFM

REMAINING TRUE TO LABEL

When the All Ordinaries Index reached 4,000, see newsletter # 5, 31 Dec 2004, we posed the question – “Is it time to sell?” And in response we detailed our three reasons for selling a stock.

1. When we make a mistake
2. A fundamental change occurs in the business OR
3. A better opportunity arises

Using our “roadmap” approach to research, see newsletter # 3, 31 March 2004, we complete the same “check and score” process each time we visit or review a company. This enables us to identify changes over time. We call them “road signs” and of course they can be both good and bad.

“we buy and sell businesses based on the merits of the individual business ”

This process remains consistent as the index hovers above 5,000. Today, we simply want to reiterate that we buy and sell businesses based on the merits of the individual business rather than movements in the index.

And when assessing the merits of a business one of the attributes we seek are managers who can also remain **true to label**. When the zero premium **Unitab / Tattersall’s** merger bid was unveiled on “merger Monday” we were not as surprised as others.

The following extract is taken from our 30 June 2005 report (Issue 8), after we visited Unitab on the 6th of July 2005. Our article was titled “An hour with Dick McIlwain, CEO Unitab” which we have reproduced below.

*“Dick McIlwain is a refreshingly likeable chap. He is laid back and straightforward. The first insight he offered us was that **Unitab** was expensive when it listed in 1999 at \$2.05. The market agreed and soon after marked **Unitab** down to \$1.85.*

*This is an interesting point. As **Unitab** hovers around the \$14 mark today, six years after listing, it still appears expensive. The price reflects a built in takeover premium and a very highly regarded manager in Dick amongst other*

things. The reality is that you do not often get to buy good companies cheap.

“you do not often get to buy good companies cheap”

*Good businesses have unique characteristics. **Unitab** for example is the sole provider of wagering services in Queensland, South Australia and the Northern Territory of which, the latter two acquisitions have delivered outstanding results for the group. Secondly, **Unitab** achieves +40% EBITDA margins on its gaming business (monitoring over 100,000 slot machines in Qld & NSW) where it is paid per machine to monitor machine payout ratios in accordance with gaming legislation in both states. **Unitab** has also added to this, the NSW linked jackpot business acquired from **Tabcorp** during 2004. With some 4,000 machines now linked and the company sharing in the pool, a move towards 5,500 to 6,000 machines would make this an exceptional business.*

*To complete the trifecta, in the past month we have also visited **Aristocrat** in Sydney and **Tattersall’s** in Victoria. **Aristocrat** is one of the few examples of a great business that did get cheap. In contrast, and not unlike Unitab, we suspect that Tattersall’s may be viewed as expensive from day one.*

“takeover premiums are counter productive and a bit silly”

*We have no doubt that **Tattersall’s** would be a good fit with Unitab. And **Unitab** has an “open door” philosophy - always prepared to look at situations. That said we are certain of only one thing. Dick McIlwain is likely to “left foot” the market and his peers at least one more time before he hands over the reins at Unitab.*

*The last insight he offered - Dick thinks takeover premiums are counter productive and a bit silly.... even in his own stock. While that may be true, it is not the only reason that **Unitab** has appeared expensive from \$2.05 through to \$14+”. **SFM***

AN HOUR OR TWO WITH THE PHARMAXIS TEAM

On the 23rd of March 2006 we sat down with the team from **Pharmaxis** (PXS), including CEO Alan Robertson, CFO David McGarvey and Investor Relations Officer Jane Sugden just after the company had reached a major business milestone.

“Good businesses aren’t for sale”

It was the same day that Australia’s Therapeutic Goods Administration (TGA) announced the approval for marketing of **PXS’s** first pharmaceutical product, Aridol. European approval should follow if the registration application lodged in April 2005 proves successful. And final phase III trials now under way in the US are expected to be completed in late 2006

Aridol is a 20-minute test designed to identify patients with active asthma and provide information on the severity of the disease and the effectiveness of their current treatment. Surprisingly, with over two million people in Australia and 52 million worldwide suffering from this disease, there was until this point, no registered and objective test to accurately measure the severity of Asthma in patients. Aridol is also in trials for patients suspected of having the respiratory disease termed chronic obstructive pulmonary disease (COPD). Thirty million patients worldwide take steroids to combat COPD, costing US healthcare US\$30 billion a year. It is thought that only 20 –25% of this group respond positively to steroids. Aridol is designed to determine who in this patient group should be using steroids. A phase II trial to determine Aridol’s effectiveness in COPD patients is expected to close in mid 2006.

The approval of Aridol is the culmination of 10 years worth of research and development work, see 31 December 2005 report (Issue 10). Its importance should not be understated as highlighted by Robertson in the company’s announcement to the market “This represents a rare example of an Australian human therapeutic product developed in Australia from concept to commercialisation”.

For us, one of the key attractions of **PXS** is that it still retains total ownership of its two lead products, Aridol and Bronchitol. This is rare in an industry that is dominated by joint venture deals done with major companies - that so often end in tears. And it’s not the majors that walk away crying. Robertson stresses, and he has remained consistent from day one, that **PXS** aims to build and own a global pharmaceutical business. And as Lindsay Fox (**Linfox**) said recently *AFR 1 April 2006*, “Good businesses aren’t for sale”. We couldn’t agree more.

PXS is clearly a company in transition, with its first product, Aridol, now set for market launch this half. From our perspective, another milestone on our “road map” has been ticked.

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AN HOUR WITH BILL IRELAND

Executive Chairman, Mariner Financial Ltd (MFI)

Bill Ireland has been around the traps for some time. In fact, he raised \$400,000 and floated **Challenger** on the Hobart stock exchange a week before the 1987 crash, so he has staying power. Some sixteen years later, Ireland successfully merged **Challenger** with the late Kerry Packers’ **CPH Investment Corp** and headed for the exit. Ireland noted that “today **Challenger** somehow supports a \$2 billion market capitalisation”.

“today Challenger somehow supports a \$2 billion market capitalisation”.

Rather than riding off into the sunset, Ireland acquired a controlling stake in a listed cash box **Australian Asset Corporation** in May 2003, was appointed Managing Director and subsequently changed the business name to **Mariner Financial Limited**. Today, supported by a loyal band of high net worth families ready to co-invest (similar to the original Babcock & Brown model), **Mariner** somehow supports a market capitalisation in excess of \$100 Million. With \$630 million of Gross Assets under Management, **Mariner** should turn a modest profit in 2005 –06.

Ireland, following in the well worn footsteps of **Macquarie, Babcock, Allco, Challenger**, and now even **Westpac**, has established an

infrastructure fund on the back of the \$100 million acquisition of the Moomba to Sydney methane pipeline. Ireland noted that competition in terms of acquiring assets and packaging them is intense at the big end of town, but smaller assets such as the Moomba pipeline doesn't hit the radar of the big boys.

“we are hoisting the flag of caution”

He also cautioned on the aggressive asset lending procedures of the major foreign banks, which are once again lending aggressively on our fair shores. To acquire a building with a coupon (yielding to the holder say 8-9%) it may now be possible to receive up to 100% funding from the banks as well as getting assistance in raising the equity component of the deal. This compares to borrowing costs typically in the 6-7% range. Domestic players like **NAB** or **Westpac** in contrast, typically lend up to 65%, so they now have to compete in a field of white hot contenders.

Like Ireland, we are hoisting a flag of caution. This practice of using superannuants to fund an asset generating a 200 – 300 basis point spread may work in a stable to low interest rate environment but a key factor often overlooked is risk pricing. Banks are pricing risk at very low historical levels. This is the premium they receive over the wholesale rate - **LIBOR** (London Interbank Overnight Rate) - or in other words the banks own cost of capital.

Put simply if rates move and banks find themselves repricing risk, then perhaps many lower quality infrastructure assets and even commercial buildings may come under enormous yield pressure. And with the growing tide of superannuation money washing into investment markets, yield has fast become the industry's Holy Grail. And we have not even attempted to paint a darker picture were capital values also to fall! Yes, this can happen to infrastructure assets and even superannuation returns. Surprisingly, this may be news to more than a few.

We are more than mindful of the changing environment now upon us, and unlike our “dancing students” and “nodding analysts”, we will continue to independently research investment opportunities, with our “road map” in tow, before moving forward. **SFM**

Understanding Investment Performance

Investment performance should be presented simply, should speak for itself and allow for easy comparison. And it should be shown **net of fees** – the amount you get to keep. Too often we see results presented before fees and charges. **SFM**

COMPANIES VISITED DURING THE LAST QUARTER:

January

OSH Oil Search *company visit*

February

COH Cochlear *European Focus Bilaterals*
 RMD Resmed *US Sleep Lab Perspective*
 PRY Primary Healthcare *results briefing*
 RMD Resmed *CEO briefing*
 VGH Vision Group *results briefing*
 TLS Telstra *results briefing*
 ROC ROC Oil *CEO briefing*
 COH Cochlear *results briefing*
 TNS Transonic Travel *results briefing*
 SAI SAI Global *results briefing*
 WDC Westfield Group *results briefing*
 ALL Aristocrat Leisure *results briefing*
 CEU Connect East Group *results briefing*
 PBL Publishing & Broadcasting *results briefing*
 CAB Cabcharge *results briefing*
 FLT Flight Centre *results briefing*
 BNB Babcock & Brown *CEO briefing*
 TTS Tattersall's *results briefing*
 FAN Fantastic Furniture *results briefing*
 SEM Select Managed Funds *results briefing*

March

AVV AAV *results briefing*
 FCL Futuris *CEO briefing*
 ABB ABB Grain *CEO briefing*
 Unlisted CBH Group *CEO briefing*
 GNC Graincorp *CEO briefing*
 ICT Incitec *CEO briefing*
 Unlisted ThoroughVision *CEO briefing*
 HFA HFA Holdings *float briefing*
 KYC Keycorp *management meeting*
 SEL S8 *CEO briefing*
 DXL Dyno Nobel *float briefing*
 PXS Pharmaxis *management meeting*
 UTB/TTS Unitab/Tattersall's *merger briefing*
 SIP Sigma Pharmaceuticals *results briefing*
 TEN Ten Network *results briefing*