

# S F M

*Funds Management*

## Q1 2004 NEWSLETTER

SELECTOR FUNDS MANAGEMENT LIMITED

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**1 YEAR GROSS RETURN WITH SFM<sub>MP</sub>**

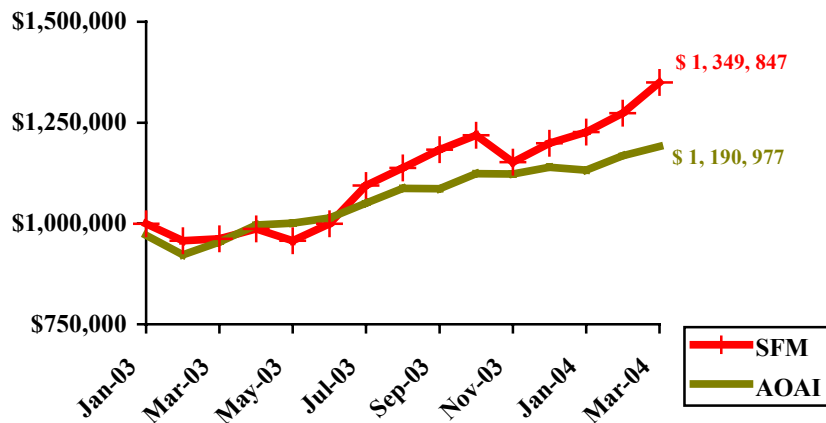
| 1 Year return | \$ Valuation | SFM return 1 Year | \$ AOAI   | AOAI return 1 Year |
|---------------|--------------|-------------------|-----------|--------------------|
| 4x Q's 2003   | 1,199,095    | 19.91%            | 1,139,900 | 13.99%             |

**QUARTERLY GROSS RETURN WITH SFM<sub>MP</sub> SINCE INCEPTION\***

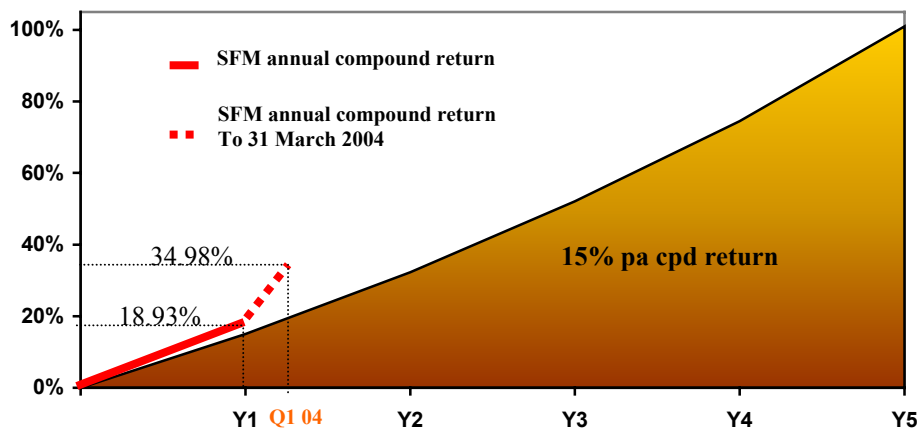
| Last 4 Quarters | \$ Valuation | % SFM Quarterly return | SFM return since inception | All Ords Accumulation Index | % AOAI Quarterly return | AOAI return since inception |
|-----------------|--------------|------------------------|----------------------------|-----------------------------|-------------------------|-----------------------------|
| Jun Q 2 2003    | 999,795      | 3.94                   | <b>34.98 %</b>             | 15,818                      | 6.25                    | 19.08 %                     |
| Sep Q 3 2003    | 1,183,388    | 18.36                  |                            | 16,941                      | 7.10                    |                             |
| Dec Q 4 2003    | 1,199,095    | 1.33                   |                            | 17,787                      | 4.99                    |                             |
| Mar Q1 2004     | 1,349,847    | 12.57                  |                            | 18,581                      | 4.46                    |                             |

\*Selector Fund Start Date 21/01/2003. Valuations adjusted for dividends previously not included

**GROSS VALUE OF \$1.0M INVESTED WITH SFM<sub>MP</sub> SINCE INCEPTION**



**TRACK RECORD AGAINST AIM OF COMPOUNDING AT 15%**



**Comment:** We have had a great quarter and again we acknowledge the tail wind provided by the climate for equities. A couple of things we would like to make clear...

*Warren Buffett does not work at Selector & surprise, surprise nor is he our Chairman.*

As a result we don't hold out that we do things the same way as Buffett (i.e. we can't afford to buy 100% of a company, which is what he typically does. This is conveniently overlooked by Buffett devotees). Instead we ask ourselves a question. Can we double our money on this investment over 5 years to achieve our goal of a 15% compound return? If the answer is yes, we use a 3-step process to build an investment road map that has milestones we can check off on the journey and road signs to warn us along the way.

1. Qualitative and Quantitative investigation
2. Develop investment roadmap
3. Road map / \*Milestones / \*\*Road signs

| Qualitative   |  |   | Quantitative                                 |   |  |
|---|--|---|--|---|--|
| Management Qualities                                    | Owner Qualities                                | Focus   | Growth                                       | Business Qualities  | Balance Sheet  |
| Individuals who we can trust                            | Material equity holding in the business        | Niche or franchise  | Reinvesting in the business                  | Businesses that we can understand   | Low debt levels                                      |
| Possess the drive to take the business forward          | Share a common bond with ordinary shareholders | Adapt to business conditions. Do not succumb to share market pressure | Drive & resources to deliver real EPS growth | Well positioned in chosen industry  | Simple structure                                     |
| Clear articulation and consistency of business strategy | Track record                                   |   | Free cash flow                               | Strong or improving financial ratios<br>ROE = return on equity,<br>ROA = return on assets | Manageable Cap Ex = Capital Expenditure requirements |

↓ INFORMATION USED TO BUILD AND REVIEW ROAD MAP ↓

| Investment Road Map  |
|--|
| 1. We build an investment Road Map                             |
| 2. Road map has <b>milestones</b> – Quantitative & Qualitative |
| 3. <b>Milestones may act as triggers – Buy / Sell / Hold</b>   |
| 4. <b>Road signs</b> alert us to changes in our road map       |
| 5. Road signs are heeded and investigated                      |
| 6. <b>Road signs can act as triggers – Buy / Sell / Hold</b>   |

\***Milestone** = Management or SFM expectations & forecasts

\*\***Road sign** = Any change to Quantitative or Qualitative factors listed. See also Page 4 Big Picture.

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**Portfolio:** In mid March, SFM met with the brand new Aristocrat (ALL) CFO Simon Kelly. Kelly is a change management specialist having had 5 separate roles in 8 years at Goldman Fielder, heading business units that required turn around. We established that both Kelly and Paul Oneile (CEO) took on their respective roles, knowing full well that a “cultural” change was needed but holding a common view that ALL remained the world leader in its space –i.e. distributor of video programs to the worldwide gaming market. SFM shares the view that ALL is a leader but we gained a bump and bruise before being rewarded. But even more importantly, this view was recently reflected in the Goldman Sachs (GS) 4<sup>th</sup> Annual USA Slot Machine Survey. GS state,

*“ The increase in popularity of Aristocrat  
Leisure games was remarkable.”*

“Aristocrat games were mentioned 19% of the time as having the highest win per machine. This ranked second only to IGT”. The report goes on to conclude that ALL has established itself as a clear No.2 in the USA behind IGT. Having gained an insight into what attracted the new team we tried not to dwell on the past. However, it became clear very quickly that credit control and debtor management in overseas operations has been reined in by new systems and procedures as a result of past failings (to our surprise no systems existed to chase overseas debtors under previous management). We also gained insight into Kelly’s view on litigation – while ALL cannot comment on insurance – it is also clear this will not be a distraction to management, who prefer to focus on quality earnings growth. We note that litigation is likely to be drawn out and our guess is that the class action may not have a huge following. In any case, future years of quality earnings growth is by far the best panacea for what will in time be viewed as a “one off” from yesteryear.

We expect ALL to surprise on the upside in the near future as the USA participation model gains further traction and the financial benefits become fully understood by investors. This is a powerful strategy that allows ALL to share in the daily winnings from an individual machine. Machines are owned and serviced by ALL in banks of 8. Currently ALL has 2755 machines on participation in the USA (IGT have 35,000 earning 50 – 70 USD per day). ALL had a substantial reduction in debt in the full year and now has a focused team at the helm. ALL scores many direct hits on our matrix above.

#### **SFM**

**Portfolio:** We think that saying no to most investment opportunities is important and can be difficult if you do not have a criteria and method for the sorting process. We attended the Zinifex (ZFX) institutional briefing in March. The first thing that struck us was the huge capital expenditure required just to stay in business, at + \$200 million in year 1 alone. This is almost Qantas – like. We avoid these types of capital-intensive businesses when the capital is used just to stay in business. This is a very different proposition to capital expenditure that is used to grow a business (i.e. ALL had cap ex of \$30M in 2003 of which \$18M was used to place machines into the participation model – see review above). Secondly, ZFX concentrates are shipped to Tasmania, Clarkesville (USA) and the Netherlands. We note that shipping freight rates are rocketing north – so much so that the ACCC is considering intervention. And for a stock touted to give exposure to a resource boom ZFX has a very high exposure to smelting. Our understanding is that refining costs are falling – this is the case at Korea Zinc, the world’s largest zinc smelter. On a comparative basis

*Kagara Zinc stands head and  
shoulders above Zinifex.*

KZL also fits neatly into each of the criteria’s we have listed on page 2 (other than Niche / Franchise). We have followed KZL closely over the past year – and we will embark on our second site visit in June 2004.

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The risk profile at **KZL** has now dropped substantially and we anticipate the next milestone of strong free cash flow will be achieved this month and will continue for a considerable period of time. And with management having significant equity we expect to see a dividend policy unfold. In resource stocks, grade is king and **KZL** is a high-grade operation with low cash operating costs. Surprises may come from the high-grade copper that has been partially defined. In contrast to **ZFX**, **KZL** trucks all concentrates to Korea Zinc in Townsville, who take 100% of production. In relation to zinc we also note the following comment from a leading research house. “Zinc’s fundamentals are improving. Demand growth is picking up and we believe that the global market has now moved into deficit. In the longer term we see relatively few major greenfield opportunities for zinc producers, so that there is potential for the global market to remain in deficit throughout our forecast period (2008)”. **SFM**

**Big Picture:** Selling is an aspect of investing that is often overlooked and rarely discussed. However, it really makes or breaks a good investment strategy. We have our own simple rules that make sense to us – not Warren Buffett rules or any one else’s. Firstly, emotion must be removed from selling. The No.1 emotion that results in selling an investment at the wrong time is fear. Two examples of fear are selling for fear of success – i.e. locking in what seems like a good profit. And secondly, selling for fear of failure – i.e. fear of losing too much money. Both of these are a result of focusing on price action alone. These are two of the worst reasons to sell. We say this for the simple fact that selling as a result of fear and price action demonstrates a lack of understanding of the fundamentals. And if this is the case

*you are not investing ... you are speculating.*

Discipline and confidence are required to establish and adhere to your own selling rules. We focus on the exact reasons that we entered an investment (see matrix page 2). If one of these factors change, it acts as a “**road sign**” – we simply heed the warning and investigate. From here we make a decision to act or take no action. This does not guarantee that we are correct but it maintains a focus on the fundamentals. A common “**road sign**” might be a change in debt levels – this deserves investigation every time. We will sell as a result of a “**road sign**” that demonstrates the company no longer meets our requirements. Typically, on investigation, we find that one “**road sign**” leads to another. In sharp contrast to this, we will also adjust a winning position – so as not to create excessive risk in the portfolio as the position grows of its own accord. This allows us to hold onto a strong performer longer, rather than getting off a winner too early. We mention this in context to our philosophy of having a concentrated portfolio. **SFM**

*“April is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, October, November, May, March, June, December, August, and February”.*

Mark Twain

## Investing with Selector Funds Management Limited.

**The minimum investment in the fund  
is \$500,000 or \$100,000  
for those investors who meet the  
wholesale exemption criteria  
within the Corporations Act.**

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**Selector Diary Q1 2004**

| Companies visited in Q1 2004 |                          |     |
|------------------------------|--------------------------|-----|
| 08-01-04                     | SAI Global               | SAI |
| 14-01-04                     | Sirtex                   | SRX |
| 21-01-04                     | HPAL                     | HPX |
| 29-01-04                     | IT & E                   | ITE |
| 02-02-04                     | Prana Biotechnology      | PBT |
| 09-02-04                     | Gunson Resources         | GUN |
| 10-02-04                     | Pacific Brands           | PBG |
| 12-02-04                     | Telstra                  | TLS |
| 12-02-04                     | James Hardie             | JHX |
| 12-02-04                     | Record Investments       | RCD |
| 17-02-04                     | Kimberly Diamions        | KIM |
| 17-02-04                     | Cochlear                 | COH |
| 19-02-04                     | Ion                      | ION |
| 19-02-04                     | Globe International      | GLB |
| 19-02-04                     | Flight Centre            | FLT |
| 20-02-04                     | Australia Energy         | AEN |
| 24-02-04                     | Keycorp                  | KYC |
| 24-02-04                     | Kaz Group                | KAZ |
| 25-02-04                     | Infomedia                | IFM |
| 26-02-04                     | Macquarie Infrastructure | MIG |
| 26-02-04                     | Millers Retail           | MRL |
| 27-02-04                     | DCA Group                | DVC |
| 27-02-04                     | Arrow Pharmaceuticals    | AWP |
| 02-03-04                     | National Foods           | NFD |
| 03-03-04                     | Peppercorn Management    | PMG |
| 03-03-04                     | Peppercorn Investment    | PIV |
| 03-03-04                     | AAV                      | AVV |
| 04-03-04                     | SFE                      | SFE |
| 09-02-04                     | Zinifex                  | ZFX |
| 10-03-04                     | Salmat                   | SLM |
| 10-03-04                     | STW Group                | SGN |
| 15-03-04                     | Aristocrat Leisure       | ALL |
| 16-03-04                     | Pharmaxis                | PXS |
| 19-03-04                     | Amadeus Energy           | AMU |
| 23-03-04                     | Sigma                    | SIG |
| 23-03-04                     | Toll Holdings            | TOL |
| 23-03-04                     | Willmont Forests         | WFL |
| 24-03-04                     | So Natural               | SNF |
| 26-03-04                     | Kagara Zinc              | KZL |
| 26-03-04                     | MPI Mines                | MPM |
| 30-03-04                     | Transonic Travel         | TBA |
| 30-03-04                     | Treasury Group           | TRG |

| SFM MP Alphabetic order of Top 10 Holdings |                      |     |
|--|----------------------|-----|
| 1  | ABC Learning         | ABS |
| 2  | Aristocrat Leisure   | ALL |
| 3  | Kaz Group            | KAZ |
| 4  | Peppercorn Inv Trust | PIV |
| 5  | Reece Australia      | REH |
| 6  | Sigma                | SIG |
| 7  | STW Communications   | SGN |
| 8  | Suncorp              | SUN |
| 9  | Ten Network          | TEN |
| 10   | Petsec Energy        | PSA |

| SFM MP Activities during Q1 2004 |    |
|----------------------------------|----|
| Share transactions               | 5  |
| Purchases                        | 3  |
| Sales                            | 2  |
| Takeovers                        | -  |
| # Investments in fund            | 26 |
| # Investments > 3% fund          | 14 |
| # Anchor stocks                  | 10 |
| # Situations                     | 11 |
| # Turnarounds                    | 5  |
| # New Public Listings            | -  |
| # Placements                     | -  |
| Other Issues                     | -  |
| Company visits                   | 2  |
| Company presentations            | 29 |
| New Companies Reviewed           | 11 |