SFM

Funds Management

# Q3 SEPTEMBER 2003

# NEWSLETTER

**SELECTOR FUNDS MANAGEMENT LIMITED**

*Australian Financial Services Licence*

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**WELCOME** to the first quarterly report of Selector Funds Management Limited (SFM). The SFM model portfolio (SFM $_{MP}$) was started on 21 January 2003.
The model will illustrate the performance of SFM on an ongoing basis. Our table below is based on an investment of $1.0M with SFM. The value of $1,000,000 invested in Jan 2003 is **$1, 173, 601** an absolute return of **17.36 %** for the 3 quarters or 9 months to September 30, shown below against the All Ordinaries Accumulation Index (AOAI).

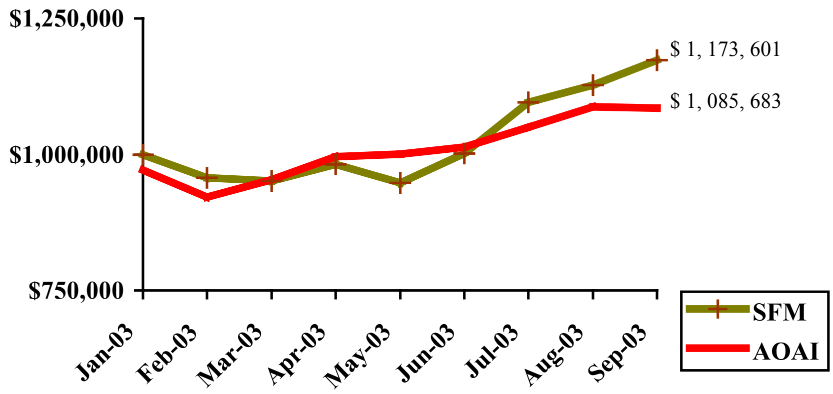
## SFM$_{MP}$ performance table since inception

| Q 2003 | $ Valuation | % SFM Quarterly return | SFM return since inception | All Ords Accumulation Index | % AOAI Quarterly return | AOAI return since inception |
|---|---|---|---|---|---|---|
| Jan Start | 1,000,000 | 0 | | 15,607 | 0 | |
| Mar Q 1 | 950,830 | -4.92 | | 14,888 | -4.61 | |
| Jun Q 2 | 1,002,330 | 5.42 | | 15,818 | 6.25 | |
| Sep Q 3 | 1,173,601 | 17.09 | 17.36 % | 16,941 | 7.10 | 8.55 % |

*Selector Fund Start Date 21/01/2003*

The performance of the fund on a quarterly basis is illustrated in the table above. Our quarterly report will cover a few of the investments that have impacted our portfolio over the quarter. It will include some dialogue from business managers that we have interviewed and a few of the observations made in our travels and readings, and the occasional non-work related experience. SFM

## Value of $1.0M invested with SFM$_{MP}$ since inception




**Overview**: For some months now (since March 13, 2003) SFM has felt the change in sentiment towards Australian equities. We don't see the market running away from this point though individual stocks continue to do so. Many will go without us. Overall we see momentum continuing to shift from cash and bonds to equities and a bit later on from residential real estate as well. SFM is seeking and sometimes finding opportunities that are new or were yesterday's favourites. Many of the latter have been discarded along with their management teams (credibility) who are now, not surprisingly, cautious when approached by market professionals. Overall we have found that this caution is a common theme among business managers interviewed by SFM in Q3 2003. Upside surprises can occur in this climate. SFM



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Our **KAZ** (KAZ) computing meeting with MD Peter Kazacos during June was an example of a battle-scarred leader. Peter now rates his public company management ability as "C" and strategic planning as an "A". As a result he is moving aside or planning a reshuffle. SFM's meeting all but confirmed that the market capitalization of KAZ was grossly undervaluing the company. At 15¢ the AAS super business alone was worthy of the entire $100M market cap. We expect AAS would interest at least Computershare. KAZ has no net debt and a strong base business and was ignored by the market. No broker research could be found in June. "Music to our ears". Peter was quietly confident on the DIPs software. Since that date a JV was announced with ANZ who are users and now believers. The software allows a cheque to be passed once instead of three times prior to clearance, meaning one processing fee instead of three, compelling? Well, yes but the US market is not without major competitors in this business, IBM and EDS. SFM positive catalysts include management & board additions (should be announced in the Q4 '03) along with a capital management program and DIPs software pilots. KAZ provided the portfolio with a 71.5% return. SFM


COREY VINCENT

Another management team previously under heavy fire - has now departed **Aristocrat** (ALL). If only SFM could report that we started buying this one at the bottom! Well, we started much higher but also confidently added to the position when the company was briefly priced for failure. We are still marginally down on this one though we can see our way ahead. ALL is the largest gaming machine company in Australia. Despite setbacks, the ALL technology and gaming platforms remain highly regarded throughout the gaming industry. The communication and lack of transparency of the disastrous foray into Colombia and problems in US destroyed the then incumbent management & board and cost shareholders dearly – no argument from us. However, the uncertainty and negative press created an opportunity where value in brand & market position coupled with high barriers to entry ensured world-class value remained in the franchise. We were convinced of this and remained unshaken by the **volatility** (panic) created by the large institutional "change of heart" that led the stock towards its adjusted issue price of 76c. Aristocrat will certainly resolve the management gulf created over the next 12-24 months. Our investors should be aware that this stock has had a significant impact on our model portfolio. We got caught in the downdraft but bailing out when value was clearly apparent was not the right strategy in this situation. This is short-term pain (due to volatility) that has been offset by other short-term performers. We remain focused on the longer term. The release to the market on 12 August had positives for us including strong cash flow (key) and substantial cost cutting. We think the lifespan chart of individual markets that ALL are licensed to operate in provided good insight into the development stage of each country. Positive tones are coming from management who by now would have learnt to be conservative (remember our cautious management theme). A couple more negatives as ALL progress would not surprise us. Two steps forward one step back. SFM

Between the two of us, Tony and I have visited companies and business leaders for more than 30 years. Yet each time we are still amazed by how much we learn from each visit regardless of the perceived investment merit. Obviously this is one of the real joys we get from our jobs. On our visit to Brisbane in late July we met up with two passionate managers.

At **Flight Centre's** (FLT) head office in Brisbane we manoeuvred out of a cramped lift. With overnight bags in hand, we eased into a one-person wide corridor with doorway. Graham Turner, who has his own desk, looked at us and laughed saying he had "no room for us". We had to go across the road to the coffee shop for our meeting. Cost control exists at FLT. The FLT model is simple. It's built for growth and the systems are in place for the group to increase shop numbers by 15-20% pa. EBIT growth can remain above 15% in a bad year. The group's brand extension and geographical spread gives FLT inherent protection against one off events, evidenced by this years result.

Graham is wary of the threat that major airlines pose in reducing or eliminating the payment of commissions. FLT's market share and sales muscle is a position of strength in this area. We learned that the future could result in alliances of a different nature and FLT's muscle will lead to a seat at the table. We were also surprised to learn that Qantas and Virgin actually complain about the commissions generated by a business introducer such as FLT's. SFM view FLT as a core holding but currently fully priced.
As an aside, in a recent article in BRW, Qantas CEO Geoff Dixon talked about his airline going broke. Far fetched? Maybe one for the memory bank. We will mark this QAN road sign. QAN core cash flow is reducing as profit has increased. SFM


Occasionally there are stocks you just don't want to talk about. You prefer to keep them to yourself a bit longer. They often start with a compliance listing and absolutely no fan fare. They can be difficult to buy due to liquidity.

**Arrow** Pharmaceuticals Limited (AWP) is a developer of generic pharmaceutical products and a distributor of pharmaceuticals for Australian and international pharmaceutical companies across Australia. SFM met with the founders during June. The simple message being that this father and son team are the driving force behind the growth in generic (off patent) drugs in Australia. AWP will aggressively increase market share from 20% to 50% of the generic market, attacking the market leader (75% +), who they also founded! and later sold to the complacent German, Merck. The generics market is expected to grow from 15% to 30-40% of the overall prescribed drugs market in Australia of $6-$7b over the next 5 years. Big picture view - it would not surprise us to see AWP being taken over in years to come by a multinational group. Margins are likely to grow from 5% to the 20's in coming years. SFM

Another quiet Australian stock is **Reece** (REH) Australia Ltd. REH are plumbing, building and hardware merchants in Australia. The company operates 186 plumbing centres throughout Australia. REH are highly focused and majority owned by the low profile Wilson family. No debt, massive franking credits and net profits of $46.7m were delivered for the 2003 year. SFM

Core portfolio holdings are important. **Suncorp Metway** (SUN) is a Queensland based bank and general insurer. The company's main business divisions are Banking, Investment and Insurance Services. SUN's strong market position in Qld remains a key attraction as well as being the 2nd largest general insurer in Australia after IAG. SUN have not yet got the full benefits from the GIO acquisition and recent management changes have renewed the focus to extract value for all shareholders. SUN is a very conservatively run organization with an excellent track record of paying out increasing levels of fully franked dividends. SFM

SFM noted in Q3 that **Optus** and **Telecom NZ** were flagging a potential industry change of fortunes. We believed this would be followed by the teleco market sentiment at some point. **Telstra** (TLS) is a wonderful cash flow business that will confound the critics and deliver real and tangible growth in an industry that despite the problems of the past few years will continue to show natural growth. A moderate PE and a high fully franked dividend provided us with a rare opportunity to buy. The August '03 broadband update convinced us that this is more than a staid utility.
Also worthy of note is the recently released ACCC Telecommunications Market Indicator report. It states that Telstra's market share for all fixed line services is 90%, share of local calls is 78% (followed by Optus at 10%), share of domestic long distance is 71%, share of international long distance 64% and



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75% of fixed to mobile. This stranglehold exists after seven years of deregulation, competition, one telco boom & a bust. It remains a core portfolio holding for Selector. SFM

In the quarter SFM profitably disposed (under takeover) of **Bristile** (BRS)**,** which will become a part of Brickworks over the next month or so. SFM

**Observations for Q3.** We look to the long term for both our investment style and the way we run our business. As we mentioned earlier the attitudes of the great managers we meet often rub off. SFM also met with **Eddie Groves** in Brisbane from **ABC Learning** this quarter. Eddie is very dynamic and lives and breathes the business he runs, as good managers do. He explained his business model (and the industry) on a white board in 12 minutes with help from the calculator on his mobile phone (not the heavy handed Hewlett Packard type). Tony has liked and followed this business but it was my first encounter. Importantly, we understood his model quickly. Aside from that, Eddie's energy radiates – makes you very excited about taking your own business to the next level, or going for a run! This brings me to **Sarina Russo**. Sarina is a bit of a guru in Brisbane. Being from Sydney, SFM had not heard of her. We bought and read her book "See you at the Top". Both Eddie and Sarina have taken a long-term approach to their businesses and acknowledge that mistakes will occur (short term setbacks). Eddie in particular acknowledges that his business is at a very important stage. (Acquisitions / integration / growth / wages/ maintaining control etc.) We thought it was important that he recognised this particularly with the great success he has had since listing. We relate these two longer-term attitudes to our investment style. SFM just can't advocate selling a stock on a short term set back alone. Yet as long-term investors we know that they (setbacks) are just around the corner for all stocks. Easy example 1, Aristocrat in South America. 2, Keycorp's announcement on 13 August after a stellar cash flow report a week earlier. These are just two quick examples. By comparison its like when your water heater leaks and water pressure disappears. You don't sell off the laundry in order to escape the short-term pain. You go to **Reece,** and on your visit hopefully you learn about a great company.
The most important issue for Selector as a long-term investor is to be able to distinguish between short-term issues and a "bigger picture" understanding of the business model. We tackle this on an individual business basis. SFM

**Big Picture - looking beyond Q3.** In the quarter the Australian dollar has been a key theme and we see this as part of our big picture. SFM's strategist was astute/lucky enough to have picked a strengthening AUD in December '02. Peter viewed the AUD as a side show to the real action, a weak US$, the return of the Euro & gold. Flicking fast forward we see this theme continuing to develop and a new focus on the strength in Asian economies – home of surplus $US's and $US denominated investments - and as described in "Grants Interest Rate Observer" - *an indispensable American creditor*. The Observer argues that Asian economies from Singapore and Taiwan to Japan and China have "chronic surpluses on trade, (funding US deficits) overall payments accounts, and the accumulation of foreign exchange reserves far in excess of prudential needs". "The combined forex reserves in China, Japan, Taiwan, South Korea, Hong Kong and Singapore now total $US 1 trillion and are rising by 20% a year". The Observer asks if it makes sense from an investment point of view (for Asian economies) to be financing huge amounts of foreign consumer debt, feeding an export boom that is unsustainable and at the expense of domestic consumption. As the incumbent US Government and Fed team up to maintain consumer spending (resulting in high consumer debt) Asian economies applaud from the sideline. By holding $US's they support the greenback and hold back their local unit. That the $US remains plainly overvalued and Asian currencies undervalued may be challenged by many an economist. And while much focus is placed on the US Government's strong dollar policy, in reality the large players are found in the East. The facts remain that a shift away from the current Asian policy of hording $US payments and investments will change the picture. The resultant falling $US could ignite the sideshow we referred to - $AUD and the sleeper in the pack - *Gold*. James Grant editor of Grant's Interest Rate Observer continues the theme, being particularly bullish on gold – however he offers this sobering thought to short termers and speculators. " You will be no richer for knowing that I am bullish on gold. I have been bullish at long, unprofitable intervals during the gold bear market that began before the birth of Britney Spears." We have our sights set - more comment at the end of Q4. SFM



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## Selector Diary Q3 2003

| Companies visited in Q3 2003 | | |
|---|---|---|
| 01-07-03 | Petsec Energy | PSA |
| 8-07-03 | Psiron | PSX |
| 10-07-03 | So Natural | SNF |
| 14-07-03 | Incitec | ICT |
| 18-07-03 | Julia Ross | JRR |
| 23-07-03 | Record Realty | RRT |
| 24-07-03 | Infomedia | IFM |
| 25-07-03 | ElectroOptics Systems | EOS |
| 28-07-03 | Imugene | IMU |
| 30-07-03 | Flight Centre | FLT |
| 31-07-03 | ABC Learning | ABS |
| 05-08-03 | Sirtex | SRX |
| 12-08-03 | James Hardie | JHX |
| 12-08-03 | Lion Selection | LSG |
| 14-08-03 | Bionomics | BNO |
| 15-08-03 | Rock B Society | ROK |
| 19-08-03 | IMB Society | unlisted |
| 19-08-03 | QBE Insurance | QBE |
| 19-08-03 | Great S Plantations | GTP |
| 26-08-03 | ION | ION |
| 27-08-03 | Keycorp | KYC |
| 27-08-03 | Cockatoo Ridge | CKR |
| 28-08-03 | AAV | AVV |
| 28-08-03 | Resmed | RMD |
| 01-09-03 | Globe International | GLB |
| 03-09-03 | Kaz Group | KAZ |
| 11-09-03 | Sigma | SIG |
| 11-09-03 | Lionore | LIM |
| 11-09-03 | Unitract | UNI |
| 11-09-03 | CDS Technologies | CDX |
| 12-09-03 | Austrim | ARL |
| 15-09-03 | Ten Group | TEN |
| 17-09-03 | Iasbet | IAS |
| 22-09-03 | Arrow Pharma | AWP |

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

| SFMMP Activities during Q3 2003 | |
|---|---|
| Share transactions | 16 |
| Purchases | 13 |
| Sales | 3 |
| Takeovers | 1 |
| # Investments in fund | 24 |
| # Investments > 3% fund | 15 |
| # Anchor stocks | 7 |
| # Situations | 13 |
| # Turnarounds | 4 |
| New Public Listings | - |
| Placements | - |
| Other Issues | - |
| Company visits | 12 |
| Company presentations | 34 |
| New Companies Reviewed | 15 |





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SFM visited Reverend **Bill Crews** in Q3 for the first time…no, not for guidance but to have a look at an interesting business. (Non-profit charity). Bill runs Exodus House and the "Loaves and Fishes" restaurant at Ashfield, where he feeds about 200 homeless & needy a meal each day. You can go out there for a meal if you like to learn about other people and their real struggles. (Make a donation if you do, remember, no such thing as "free lunch") They also educate kids who are dropping out of school for a variety of reasons. Bill has annual costs of around $2M. Selector Funds Management Limited and the Exodus Foundation are completing a Heads of Agreement to establish the Exodus Selector Charity Mandate. SFM aims to raise and grow a long-term fund that will provide an annual distribution (and annual compound growth) to chip away at some of this annual cost base. Our fees (after admin cost to our outsourced providers) will be donated back to Exodus. Contact Tony or Corey with enquiries. **SFM**


***The art of successful investment is the patient investor taking money from the impatient investor***

**Rugby World Cup Oct 10 - Nov 22 2003** will see 20 teams play 48 matches across 10 different cities of Australia. It is expected that 40,000 visitors (down from expectations of +50,000) will venture down under and provide a big boost to tourism during the 43day event. This is about one-third of the tourist inflow during the Sydney Olympics. Australian retail sales have been strong of late and will gain momentum from RWC going into the important Christmas – New Year selling season. The Australian Bureau of Statistics believes RWC will lead to a strong Q4 2003. Total economic benefit is expected to be $800M -$1 Billion or 0.2% GDP growth of which NSW will see expenditure of $350M for RWC. A major beneficiary will be local restaurateurs and publicans. Unlike the Olympics where most visitors spent every day and night at Olympic venues consuming various takeaway options, a rugby match lasts for 80 minutes leaving ample time to dine at restaurants, cafes and visit pubs. You may remember this experience during the 2001 British Lions Rugby tour of Australia, which brought 10,000 vocal supporters to our shores – our pubs and restaurants were a "sea of red". If you are in out and about visitors worth spotting include George W. Bush, who played rugby at college; Princes William and Harry cheering the Pom's and Nelson Mandela who will watch the Springbok go around against England in Perth. Our thoughts ….a good win against the Pumas. **SFM**

**Investing with Selector Funds Management Limited.** Several options exist for new investors with Selector Funds Management Limited. Contact Corey Vincent or Tony Scenna to make an appointment to discuss the options available to you.

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