FUND PERFORMANCE:

Since inception the Fund has returned **42.7%**, inclusive of a 1.98 cent distribution to unit holders for the period to 30 June 2005, outperforming the All Ordinaries Accumulation Index which rose by 30.5% over the same period. See the table on page 5 for the Funds performance since inception on a monthly basis. SFM

BIG PICTURE:

Is investing an art or science? While this is an age old and worthy debate we only intend to discuss the latter half. This quarter we take a look at the "science" side of business. We want to focus on the importance of Research & Development (R&D), a key feature in Selector's "Road Map" of all businesses considered for investment.

The importance of R&D is nothing new or faddish; rather it is a fundamental business characteristic that is as old as the aforementioned "art or science" debate. In his list of fifteen key elements of stock selection, Philip Fisher (*Common stocks and Uncommon Profits* - first published 1958) rated the importance of Research & Development as numbers 2 & 3.

"the closest thing to legal insider trading"

Delving into a well-executed R&D program can be a rewarding process. And it is possibly the closest thing to legal insider trading. You are literally looking at the announcements of the future. But more importantly you are looking at the future lifeblood of the company, reflecting the very source of earnings growth that most analysts are trying to forecast using discounted cash flow and other fancy models.

The converse is also a great eye opener. In a poorly managed business, an ill conceived R&D program can be a great indicator of management inconsistency, short sightedness and waste and is often a direct reflection on the management team at the helm.

Whilst we place enormous importance on a company's R&D program the accounting treatment often hides the real benefit that can ultimately flow. Most reputable companies write off the entire R&D cost in the course of the year so that its impact on the profit line can be significant to say the least. For instance, **Cochlear (COH)** in 2005 reported a net profit before goodwill amortisation of $58.3M after the company had forked out some $43.8M on R&D. Without such an R&D spend, a profit figure well north of that recorded would have flowed to all and sundry. So why do it?

Successful R&D equates to successful earnings growth delivered some time down the track, and to achieve that, there's more to it than just adding the number of dollars spent to the sum of science degrees and doctorates on hand. It is about the right people focused on the right project with a common goal and it requires three key ingredients:

1. *Co-ordination*
2. *Management understanding*
3. *Market Research*

The essence of a value adding R&D program is to only undertake tasks that produce dollar rewards several times greater than the cost of the project.

In general, teams of specialists conduct R&D requiring in most instances significant co-ordination. The degree of skill of each of the experts is only part of what is needed to produce outstanding results. Firstly co-ordination of diverse technical specialists is required. It is necessary to have leaders who can co-ordinate the work of people with such diverse backgrounds and keep them driving towards a common goal. If leadership is missing, the number of academic researchers (*cost*) in a company may overshadow by the effectiveness of the team effort.

For example, in the case of **Cochlear**, collaborative research is undertaken in 139 centres around the world. They are targeting better outcomes for existing and future recipients of cochlear implants.

Management's ability to motivate researchers to achieve the greatest productivity is not the only challenge for optimum research results.

Management's understanding of the fundamental nature of commercial research is a key ingredient to successful R&D. R&D projects cannot be started or expanded in good years only to be curtailed when lean years set in, without significantly increasing the cost and time taken to achieve an outcome.

Likewise pulling key research personnel from a project to work on a short-term goal is generally not worth the disruption caused.

"R&D… enabled Google to list… market capitalisation of US $140 Billion"

Generally, management with the greatest understanding of the importance of consistent and continuous R&D will have had direct "coal face" experience. An outstanding example are the managers at **Google Inc**. Founders Sergey Brin and Larry Page are both ex-Stanford University Computer Science doctoral students whose years of R&D endeavour ultimately enabled **Google** to publicly list in August 2004. Today, **Google's** market capitalisation isUS$140 billion. Not surprisingly, the on-going importance of R&D has not been lost on either Brin or Page, reflected in the innovative manner in which way they motivate all staff to become R&D specialists.

Google insists on "20 percent time", such that **Google** staff are required to devote 20% of their work time to an original project of their choice. Larry Page monitors the top one hundred "20 percent time" projects in the company to determine if further funding and resource concentration on a promising project may lead to a commercial application. (*The Google Story* – published Nov 2005 is a great read).

In a slightly different league, **Pharmaxis's (PXS)** CEO Alan Robertson is credited with the co-discovery of *Zomig (indicated for acute treatment of migraine)*, marketed worldwide by Astra Zeneca. Today this experience translates to leadership of more than 25 R&D projects worldwide including several pivotal phase III R&D projects in the related field of airway lung function. This includes *Aridol*, which has been filed for market registration in both Australia and Europe.

Beyond managements understanding of the importance of R&D is their need to have a thorough understanding of the market place for their products. Market research is the third critical ingredient. This is the bridge between development research and sales. Thorough market research determines if a genuine market for a product exists. It will shed light on the difficulty, time and cost required to penetrate a market. It is an essential ingredient for even the best sales force. Market research can be approached from multiple angles.

"R&D extends to all companies including miners"

A survey of the key opinion leaders in a particular field best tests the existence of a genuine market. Invariably the support of key opinion leaders, results in the undertaking of independent research and provides the best form of marketing feedback. Early product uptake by the key opinion leaders is essential to the success of a product in the market place.

Of course R&D is not restricted to just pharmaceutical or health care groups like **Cochlear** and **Pharmaxis**. As in our earlier **Google Inc** example, it is just as critical for technology companies. Even a seasoned player like **Cabcharge** prides itself on being at the cutting edge of the electronic payments industry

as a result of a consistent long term targeted R&D program. In fact, the requirement for R&D extends to all businesses in all walks of life including miners and service companies. For investors, the key is to understand what is at stake whilst monitoring events as they unfold.

At Selector, gathering such information can be time consuming and it requires oodles of patience. Seventy years ago Philip Fisher referred to this information gathering exercise as "scuttlebutt" because he didn't have a Google Search Engine. "Scuttlebutt" for us involves interviews within the company, with competition and with university researchers. We have also taken part in clinical trials of new products (only when appropriate) and of course reading from a wide range of sources, including "googling" (and now "goggle alerting") every conceivable topic. But the facts remains, properly conducted R&D is crucial to the long term health of any business and is a key feature on our investment Roadmap. SFM

AN HOUR OR TWO WITH ROC OIL

We have been following **ROC Oil (ROC)** for over two years without having made an investment. **ROC** is run by "salt of the earth" Welshman John Doran, who brought with him a solid track record driving listed group Command Petroleum, before its takeover in 1997. Our Chief Investment Officer was an investor in Command so the knowledge base on John Doran in particular extends well beyond the last few years.

We have long admired the straight up and down approach adopted by John Doran and his management team. The "tell it as it is approach" is all pervasive. The group's annual meetings, stock market releases and particularly **ROC's** annual reports are all delivered in an honest, refreshing and frank manner – a rarity for most companies let alone one operating in the oil & gas business.

We met with John Doran and chief operating officer Bruce Clement in early December to gain a better understanding of the potential of the four cash generating oil projects earmarked to come on stream in calendar 2006, as well as the significant drilling program **ROC** has committed to as both an operator and joint venture partner.

First up, John Doran explained the importance of staying on course. He refers to this as "True North". For **ROC** "True North" requires a complete focus on sticking to a core philosophy and a game plan whilst resisting the urge to sidetrack and chase more seemingly attractive shorter term opportunities.

It is an approach that has proved successful and guided **ROC** into areas that others would have barely considered, like Angola, which is only now emerging from a thirty-year civil war. This contrarian type approach has allowed prospective assets to be acquired cheaply. **ROC** management then takes a long-term approach to adding value while maintaining high levels of ownership.

This process, along with "True North", has strong appeal to us as it has all the hallmarks of the way we like to invest and conduct ourselves in business. Our first visit to **ROC's** office provided us with the big picture, enabling us to walk away with a pretty compelling view of strong profits prevailing over the next few years. Having done the preliminary work we ended up with further questions so we headed back up town to **ROC's** office just prior to Christmas.

It's amazing how much clearer the picture becomes each time you revisit a business. As a company, **ROC** meets our requirements for addition to the portfolio. We have a strong conviction in the group's business "qualities", and are confident that the financial rewards will be achieved in 2006-07. The valuation is reasonable but not compelling; however there is a high likelihood of strong real earnings growth in coming years. That said we have not yet acted, still wary of the hurdles to be jumped.

Success in the big drilling push in March 2006 could provide a strong catalyst. The converse is that disappointment may provide a compelling opportunity to acquire **ROC** shares based on the cash flow expected from the four projects coming on stream in 2006. Either way, **ROC** remains on our radar, we remain hopeful that a short term "event" will trigger an opening.

As an aside, a source of some surprise may come from the way future R&D is treated in the oil and gas industry. Generally speaking, R&D (termed exploration and development) for an oil & gas play takes many forms including 3D seismic shoots, computer generated modelling, and ultimately drilling wells. A shift is currently occurring in the way this expenditure is treated. Most companies use the "Area of interest" approach where development is capitalised rather than expensed because it may result in a future discovery. Industry leaders in the USA have led the way in adopting the more conservative "Successful Efforts accounting methodology". It entails "writing off" immediately, all exploration expenditure that does not have likelihood of commercial development. **ROC** may transition to this method in the near future.

Not dissimilar to ROC managements' "True North" mantra we are happy to understand many and invest only in a few that meet our requirements. SFM

An observation - Alan Greenspan - golden touch or trigger happy?

Former US Federal Reserve Chairman Alan Greenspan in a career spanning some 18 years has won many friends and plenty of enemies in presiding over US economic policy. Listed below is but a snapshot of events

- **1987** - When Alan Greenspan took over as head of the US Federal Reserve on 11 August, it took barely a month before he passed the first interest rate rise. The following month the US Dow Jones Index plummeted on Oct 19 by a record 22%.
- **1989** - Continues to target inflation fight, pushing rates to 9.75%
- **1989** - Quickly reverses action and cuts rates a staggering 23 times over the proceeding three years.
- **1990-91** - US economy falls into recession in even though the Fed Fund rate is finally reduced to a two decade low of 3%.
- **1994** the first rate rise in five years triggers a bear market for bonds.
- **1995-96** – Rates cut three times as inflation wanes
- **1996** – Greenspan echoes share market concern with "irrational exuberance" remark with the Dow Jones Index sitting at 6,400 (today it stands at 11,000)
- **1997-98 –** Rates lowered three times
- **1999-00 –** Rates cut six times to cool economy. NASDAQ peaks at 5,049 along with Dow before each drops 75% and 35% respectively the ensuing years.
- **2001 –** Greenspan reduces rates but again the US goes into recession
- **2001 –** September 11 attack in New York and Washington. US recession officially ends November.
- **2003 –** US invades Iraq, Greenspan progressively cuts rates to 45 year lows and warns of deflation
- **2004-05** – Greenspan begins a series of quarter percentage rate rises to prevent revival of inflation.
- **2006 –** Greenspan's term on the Federal Reserve ends on 31 January

Now we don't for a moment profess to be any economic geniuses and the scoreboard can lead to many conclusions on the best course of action. At the end of the day though it appears that the more you muddle with things the greater the consequences.

In contrast, since Ian Macfarlane's appointment as Governor of the Reserve Bank of Australia in August 1996, a deliberately low public profile and a steady hand at the wheel has seen interest rates remain relatively unchanged. Less muddling has resulted in strong economic conditions and a stock market hitting all time highs.

These are the facts – we will now leave it up to you and Dr Ben Bernanke to determine the best course of future action. SFM

COMPANIES VISITED DURING THE LAST QUARTER:

October

GGY	Glengarry Mining
CAB	Cabcharge site visit
TEN	Ten Group
QAN	Qantas
PPT	Perpetual AGM
PXS	Pharmaxis Biotech Conf.
COH	Cochlear AGM
SRX	Sirtex AGM
TLS	Telstra AGM
DVC	DCA Group
COH	Cochlear
RHC	Ramsay Health Care
SIG	Sigma
AWP	Arrow
PRY	Primary Healthcare
VCA	Ventracore
VGH	Vision Group
PBL	Publishing Broadcasting AGM
IFM	Infomedia AGM
PXS	Pharmaxis Site visit

November

BCL	Betcorp
DVC	DCA Group AGM
TNS	Transonic AGM
BNB	Babcock & Brown
TLS	Telstra Briefing
PXS	Pharmaxis AGM
ROC	Roc Oil
RMD	Resmed AGM
MIG	Macquarie Infrastructure AGM
KYC	Keycorp AGM
HVN	Harvey Norman AGM
SYM	Mayne demerger Symbion Health
CAB	Cabcharge AGM
GNC	Graincorp

December

ABB	ABB Grain
SLM	Salmat AGM
ABN	Austbrokers
SAI	SAI Global
ROC	Roc Oil

FUND REPORT as at 31 December 2005

Issued by Selector Funds Management Limited ABN 85 102 756 347, AFSL 225 316. The investment information in this Fund report is historical and refers to the period to 31 December 2005. **Past performance is not an indicator of future performance** for this fund.

PERFORMANCE SUMMARY

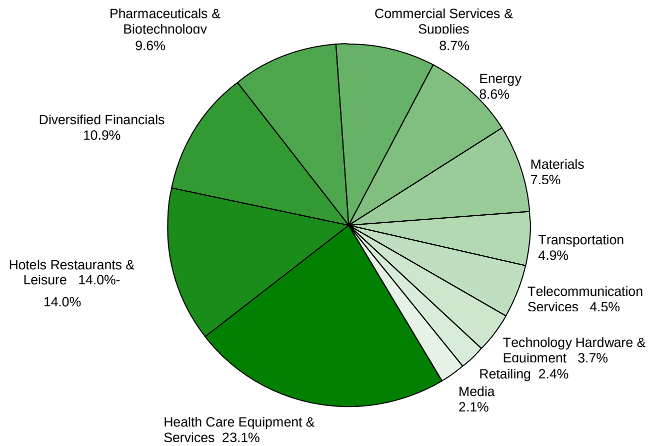
	3 months (%)	6 months (%)	1 Year (%)	Inception (%) pa
Total	**-3.68**	**14.74**	**34.26**	**42.72**
Income	-	-	1.98	1.98
Growth	-3.68	14.74	32.28	40.74
S&P/ ASX All Ordinaries Accumulation Index	**3.45**	**13.79**	**21.09**	**30.49**

Returns are calculated on an annualised basis using mid price to mid price, and are calculated after all fees have been deducted with distributions reinvested and no allowance made for tax. The 'income' component represents the amount paid by way of distribution, including net realised capital gains.

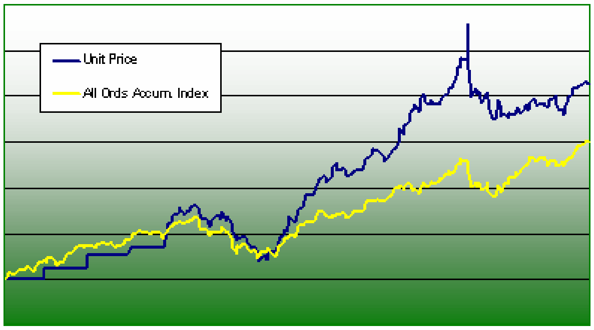
MONTHLY DETAIL

Month ending	Mid Price	Distribution per Unit ($)	Month Gain (%) Fund	Inception Gain (%) Fund	Index Level	Month Gain (%) Index	Inception Gain (%) Index
31 Dec 05	$1.4074	-	3.62	42.72	27,475	3.04	30.49
30 Nov 05	$1.3582	-	1.03	37.80	26,665	4.04	26.64
30 Oct 05	$1.3443	-	-7.99	36.41	25,542	-3.83	21.31
30 Sep 05	$1.4611	-	6.44	48.09	26,559	4.75	26.14
31 Aug 05	$1.3727	-	8.76	39.25	25,354	2.18	20.42
31 Jul 05	$1.2621	-	2.09	28.19	24,814	2.77	17.85
30 Jun 05	$1.2358	$0.0198	11.62	25.56	24,146	4.46	14.68
31 May 05	$1.1249	-	5.35	12.49	23,115	3.41	9.46
30 Apr 05	$1.0678	-	-5.43	6.77	22,352	-3.78	6.16
31 Mar 05	$1.1291	-	0.72	12.91	23,231	-0.74	10.33
28 Feb 05	$1.1210	-	4.68	12.09	23,405	1.80	11.16
30 Jan 05	$1.0709	-	2.16	7.09	22,992	1.33	9.20
31 Dec 04	$1.0483	-	2.33	4.82	22,690	3.07	7.77
30 Nov 04	$1.0244	-	2.44	2.44	22,014	4.63	4.63

Portfolio by GICS sector



Unit Price Movement vs Index since inception



To receive a Information Memorandum
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Applications for units can only be made on the application form in the Information Memorandum (IM) dated 15 October 2004 and Supplementary Information Memorandum (SIM) dated 1 January 2006. Potential investors should consider the IM and SIM before deciding whether to invest in the Fund.

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