Dear Investor,

As we cast our minds back over the events that shaped the 2009 financial year, the single most important feature was one's ability to survive the financial crisis.

So big and wide has been the fallout that no one has been spared. While the chief offenders all have the common link of too much leverage, many innocent parties have been hit in the crossfire.

Under these circumstances, navigating a market that incurred the biggest fall in 27 years and the fifth-worst performance on record has not been easy. While we can't profess to being fully satisfied by delivering our investors a negative return for the period, we are nevertheless extremely pleased to have achieved two things. First, that we delivered an investment performance considerably better than the general market. And secondly, that we kept our composure when it would have been just as easy to panic.

In the report that follows, we aim to provide some further insights into the Fund's investment holdings, the ongoing deleveraging process at work and what the immediate outlook may mean for investors.

While the road ahead is not without its challenges, we are more than comforted by the large number of excellent investment opportunities now before us.

Finally we would like to extend our appreciation to all of our investors, for staying the course during these difficult times.

Regards

Tony Scenna
Victor Gomes
Corey Vincent

Selector Funds Management Limited

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Performance June Quarter 2009

The Fund delivered a strong last quarter; rising 21.2%. The All Ordinaries Accumulation Index in contrast; rose 12.6%.

For the financial year, the Fund recorded a 10.31% fall, significantly outperforming the All Ordinaries Accumulation Index which declined 22.15%. Portfolio performance statistics are detailed on page 21.

Pharmaxis: An Australian Success Story

You may not be familiar with the pharmaceutical company Pharmaxis (PXS), but in this review we hope to outline why we rate it as an Australian success story that is beginning to capture international attention.

We first became aware of this Sydney-based business back at the time of its prospectus launch in October 2003. Always cynical of "gunna" stocks, we read the Pharmaxis document fully anticipating a quick rejection on our part. Too often, companies come to market seeking funds, ill prepared and without a thoroughly thought out game plan. In the case of biotechnology companies, the situation is made worse by the fact that the vast majority of candidates are virtual light years away from commercialising their endeavors. We expected Pharmaxis was no different but on our first reading we reserved judgment.

At several levels we noted promise. The company was asking for money at a time when general investor sentiment was still weak. Secondly, all the funds sought, amounting to some $25 million, were earmarked for product development. And finally and most importantly, the company's pipeline of pharmaceutical drugs was at an advanced stage of development, backed up by what appeared on paper to be a very experienced management team who were also buying into the offer. On listing, the company's market capitalisation sat at $54 million with cash on hand totalling $32 million. Suffice to say that our interest was piqued and we organised to meet with management at their Sydney site in Frenchs Forest.

The company's prospectus stated that "Pharmaxis is a specialist pharmaceutical company committed to the research, development and commercialisation of human therapeutic products for chronic respiratory and autoimmune diseases and the development of an improved lung function test". Setting aspirational goals may reassure prospective investors, but for us the proof was in our first meeting with CEO Alan Robertson. Here was a man clearly on a mission and one cut from a different cloth to the typical preparedness of other managers to implement quick licensing

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deals. Robertson entertained no such thoughts. There would be no short cuts but rather a clear and articulated strategy to build a fully integrated specialist pharmaceutical company encompassing research, manufacturing and marketing of its wholly owned intellectual pharmaceutical products.

Such a desire can be easily lost on those who have little understanding of what is required to bring a new pharmaceutical drug to market. The road is long, tortuous and extremely costly, with few getting to market. Milestones to success surround the various phases to prove that a drug is both safe and effective for human intake. Identifying a worthy candidate, taking it through pre-clinical research (animal studies), before embarking on the lengthy clinical (human trials) pathway referred to as Phase I, Phase II and Phase III studies, are necessary before a drug can even be considered for regulatory approval. Successfully navigating such a process has its financial rewards but simply having a good candidate is not enough.

At the time of listing, Pharmaxis's two leading products, Aridol and Bronchitol represented the culmination of ten years' worth of research. Aridol - designed as a lung function test used to diagnose and manage conditions such as asthma and other respiratory diseases - was in the final stages of phase III trials. In contrast, Bronchitol had just entered phase II studies, with a goal of providing long term effective treatment for patients inflicted with the genetic disease cystic fibrosis.

At this juncture, it would be fair to say that trying to pick winners from a field of drug candidates would be equivalent to finding a needle in a haystack. Furthermore, when we first assessed the merits of Pharmaxis, we did so without any special understanding of the science that backed up its aspirational aims. But following our very first meeting with Robertson, our ongoing interest was assured. Success, as we ascertained, was not based solely on whether the drugs worked but also on the group having the necessary capital and desire to see things through.

Critically, our confidence rested on two very important aspects of the company's drug technology. Firstly, the use of the sugar powder mannitol (commonly used as an artificial sweetener in foods) as the group's principal compound. And secondly, that its intake and mode of action, represented a physical solution to the problem rather than the drug industry's typical chemical treatment approach. To us, this appeared as a simple and novel approach that had the capability of altering how these diseases could ultimately be treated and managed.

At its core, the group's technology is founded on the use and delivery of mannitol into the patient's lungs and airways, giving rise to both a treatment and management for a whole host of respiratory conditions. In the case of Aridol, the patient is involved in what is termed a challenge test, whereby incremental amounts of inhaled dry powered mannitol is delivered by capsule into a patient's airway. The procedure takes approximately 20 minutes, is administered by either a specialist or general practitioner and is the only test capable of quantitatively measuring a patient's susceptibility to "hyper responsive airways" typically referred to as asthma or chronic obstructive pulmonary disease (COPD). The test is rapid, accurate, safe and inexpensive. In contrast, existing methods used to measure lung function have proven to be both inaccurate and inconsistent, leading to a high percentage of misdiagnosed patients. It is estimated that asthma affects some 51 million people worldwide while COPD numbers are estimated at over 30 million.

In contrast, Bronchitol has been developed for the management of various chronic obstructive lung diseases, in particular cystic fibrosis, bronchiectasis and chronic bronchitis. These are all life threatening diseases with cystic fibrosis the most debilitating. With more than 75,000 sufferers worldwide, cystic fibrosis is an inherited genetic disease that primarily affects the respiratory system. The disease is caused by a disruption to the balance of salt and water within the lungs and airways leading to a steady build up of thick mucus in the lungs. With sufferers unable to effectively clear the mucus, cystic fibrosis will ultimately lead to progressive lung function deterioration and collapse of the respiratory system. There is no known cure for cystic fibrosis and the average median survival age is 37 years.

Unlike chemically derived drugs Pulmozyme and Tobramycin, - which are taken for the treatment of cystic fibrosis symptoms but lose effectiveness as patient resistance builds - Bronchitol operates in two distinct methods. Firstly, it reduces the thickness of mucus and, secondly, it clears the mucus from the lungs, thereby restoring normal lung function and reducing the need for antibiotics. It does this in a unique mode of action whereby the drug (mannitol) mimics the action of salt in a healthy lung to physically draw water out of the cells (osmotic action) resulting in the hydration of the lungs. Ultimately, it is management's belief that Bronchitol will halt the progressive reduction in lung function thereby extending the life of cystic fibrosis sufferers.

Despite experiencing significant delays in gaining regulatory approval, steady progress continues to be made on all fronts. For Aridol, Pharmaxis succeeded in its pivotal phase 3 studies, gaining local regulatory approval in March 2006 and followed this up with marketing approval in Sweden during the latter part of the same year. Despite the long arduous regulatory process that dogs all pharmaceutical companies opening new territories, Pharmaxis now has Aridol registered for sale in fourteen European countries, as well as Korea. The group is also in the final stages of seeking approval for the US market, with an expected response from the US Food and Drug Administration (FDA) set down for 27 December 2009. Revenue continues to build slowly as full rollouts are undertaken in all key markets and awareness amongst the medical community grows. In time, it is expected that Aridol will open up a market estimated at up to A$200 million per annum.

At the other extreme, Bronchitol holds enormous promise and looks set to capture the market's immediate attention. Following the group's recent successful completion of a Phase III trial involving 325 cystic fibrosis patients, a marketing application is now being pursued with expectations that regulatory approval will be granted for the European and Australian markets in the latter half of calendar 2010. A second Phase III trial is currently underway to satisfy the U.S FDA requirement for two pivotal studies. Enrolment is expected to be completed mid-year with high expectations that final approval will also be granted during 2010. This would represent only the third product approved for the treatment of cystic fibrosis but more importantly, will be the first to offer sufferers effective, long term treatment and management of the disease. During 2008 combined sales of the only two approved products exceeded A$1.0 billion.

Robertson has set the bar high and makes no apology for the direction taken and the quantum of shareholder funds invested to date. At last count, Pharmaxis has raised a total of $250 million from investors in its pursuit of building a specialist pharmaceutical company. Of the funds raised, some $90 million has been directed towards research and development expenditure necessary to complete a multitude of human pharmaceutical trials. Another $17 million has been outlaid on the group's

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newly completed 7,000 square metre purpose built manufacturing facility and company headquarters. This facility will allow for an initial production capacity of 40,000 patients per annum. The remaining bulk of funds, some $130 million is held in cash, as the group looks to embark on the worldwide commercial launch of Bronchitol. With its own dedicated sales and marketing team, Robertson aims to keep a tight grip on the group's prized intellectual property and the majority of revenue streams that flow from it.

From a standing start, Robertson expects Bronchitol to capture 30% of the cystic fibrosis market within 18 months of launch, rising steadily thereafter. His confidence is borne out in the fact that Bronchitol not only works better than the existing drugs and is easier to administer but that it will go one step further and change the course of this disease – to one that provides sufferers with a long term solution. And getting the message across to the tight-knit cystic fibrosis community should carry few challenges. With some 320 cystic fibrosis centres established throughout Europe and another 150 in the US, commercial marketing manager Gary Phillips and his team will promote directly to the end users.

And what will it mean if Pharmaxis gets it right commercially? Below we provide our financial snapshot if management captures their initially stated aims of 30% of the cystic fibrosis market, ignoring for this exercise the larger and broader respiratory market potential.

Main Markets	**Cystic Fibrosis Sufferers**	**Pharmaxis 30% Market Share**	**Sale Price for drug Equivalence**
US market	30,000	9,000	$US22,000
Top 5 EU Countries	27,000	8,100	$US13,000
Total	57,000	17,100	$US17,700 average

2012 Full Year Launch	**US**	**EU**	**Total**
Revenue US$ M	198	105	303
Gross Profit US$ M	168	89	257
EBIT US$ M			182
NPAT US$ M			127
NPAT A$ M			159
EPS			72.0¢
PER ($2.50)			3.5x

The task ahead is not without its challenges. From this point on management will need to succeed on a number of fronts to enjoy the commercial rewards of their endeavours. Critically the next 12 - 18 months is important and any delays in manufacturing, gaining marketing approvals, or hitting eventual sales targets will come at a significant overall cost to the group.

That noted, the results to date plus the will and commitment within the Pharmaxis team is obvious to anyone who has followed the company's endeavours since 2003 along with Robertson's sense of purpose – "I don't want accolades, I don't do it for peer group recognition. It's all for the end use of the patient struggling with these horrible, debilitating, fatal diseases.'

From our vantage point, there is a lot to like about the company and the road that it now finds itself on. Perhaps in the not too distant future when the likes of Cochlear, CSL and ResMed are highlighted as examples of great Australian success stories, another may find itself added to the list.

Earnings Dilution

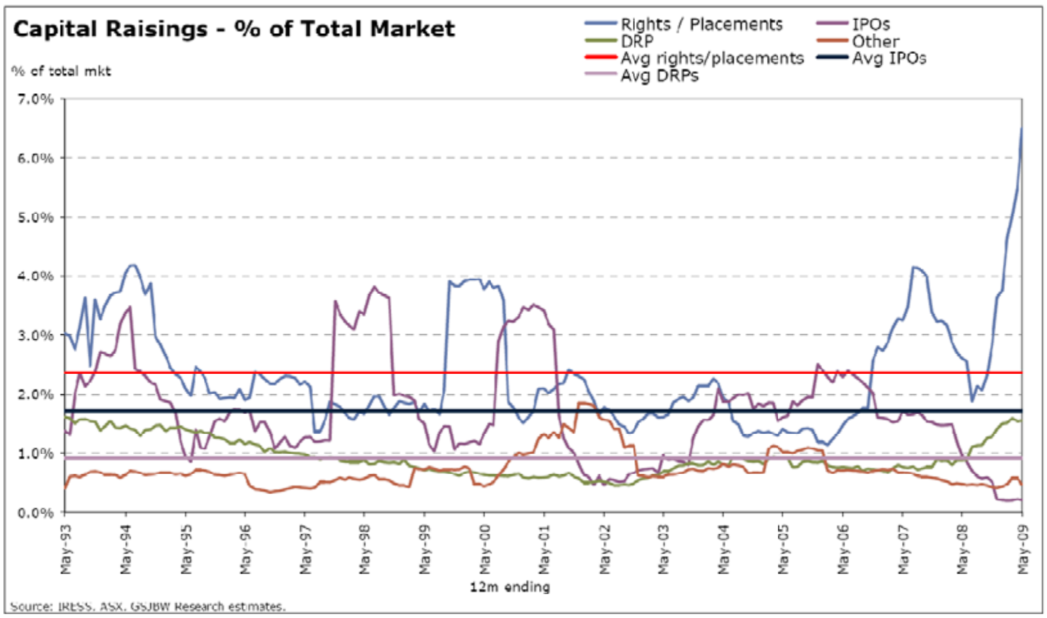
When we cast our minds back to the events of late 2008, what was becoming abundantly clear even then has turned into the full blown reality of today. With banking and investor confidence shot to pieces and stretched balance sheets a common theme, the chances of things ending nicely were never high. As we noted in our September 2008 quarterly newsletter, the thing we feared most was the deleveraging process that would inevitably follow.

Unlike governments which can indulge in that wonderful art of printing new money when called upon, individuals and businesses have no such luxury. And as such it was only a matter of time before the question of debt would command centre stage. Specifically, the treatment of debt would take on many traditional characteristics. Firstly it would return to its rightful place, being repriced appropriately for the risk undertaken. Secondly, debt would be voluntarily or forcibly repaid. And lastly, debt would be denied.

Under such circumstances, new capital becomes very expensive and for our part, one of our key "roadmap" aims is to avoid precisely this scenario – where companies are forced to go cap in hand to raise expensive new capital during times of financial weakness.

But these are precisely the circumstances that investors must now face. Following the share market's low point in mid march, what started as a trickle has turned into a raging torrent as company boards and executives look to raise new capital to pay off nervous bankers and reduce excessive levels of debt. In some circumstances, the raisings have been sensible; simply reflecting a more conservative outlook. In others, the stark reality has left few alternatives.

Graph 1:



Graphs 1 and 2 highlight the current state of play. Since December 2008, new capital raisings as a percentage of the total market's capitalisation, jumped sharply, approaching peaks last set in 1992. To put that into some context, since peaking in September 2007 at $1,643 million, the All Ordinaries market capitalisation value of all listed stocks had fallen to $1,048 million by May 2009, down 36%.

Compare that to Graph 2 where a slew of secondary capital raisings has seen close to $80 billion of new equity raised during the 2009 financial year. Unlike a number of other asset classes, share markets and investors adjust to circumstances quickly, historically leading on the way down and bottoming well before economic conditions turn up. Unfortunately, those who are waiting for the green light before returning to the market may be disappointed as market and investor psychology rarely operate in tandem.

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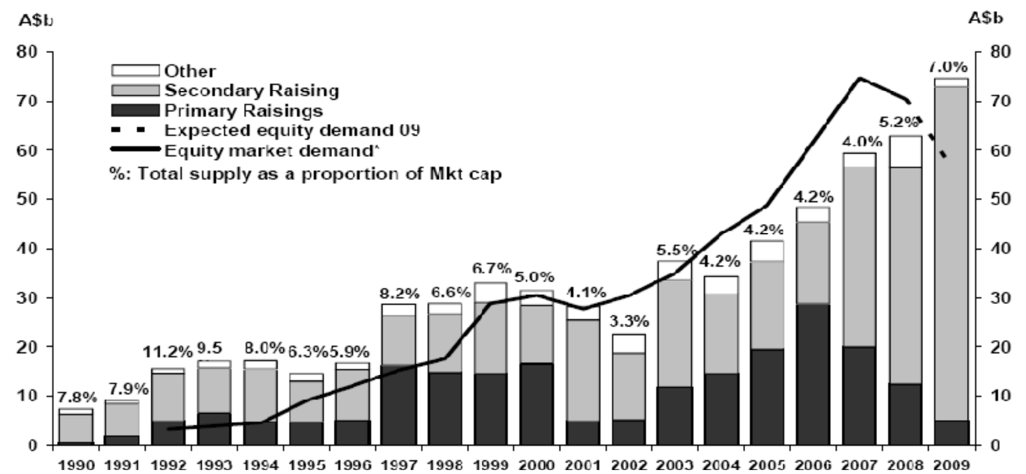
Graph 2:

Capital raisings relative to mkt cap (7%) remain below that seen in 1990s



*Equity market demand – Inflows from superannuation, dividends, buybacks
** Based on year to date data therefore a higher degree of certainty exists for this forecast

Source: IRESS, ASX, Macquarie Research, June 2009

The numbers above would seem to indicate that the offers on hand have been too good to refuse. But there is a price and that is earnings dilution. As Graph 1 highlights, the extent and breadth of capital raised has been, in a word, extraordinary and reflected in the blow out of a company's issued capital. It seems everyone now wants to get rid of as much debt as possible and return to that once pillared world of running lazy balance sheets.

However, the expected fall in earnings is now compounded by the sharp rise in shares on issue, leading in some cases to massive earnings dilution. Shareholders have been left with few choices but to participate. While some, including Westfield, Primary Healthcare and Billabong have engineered an excellent outcome under the circumstances, others including Asciano, BlueScope Steel, GPT and Transpacific have been severely impacted. In some instances the likes of Fisher & Paykel Appliances and Kagara have probably made the best of a bad situation, with the introduction of significant new cornerstone investors.

All in all, the unwinding of debt is likely to continue for some time. In due course we expect attention to shift to the next leg of market recoveries – that of mergers and acquisitions. Already, the arrival of Chinese investors seeking to acquire hard assets is but a taste of things to come. Rightly or wrongly, investor attitude to risk will change, bringing with it a different perspective to the opportunities on offer.

This is not to say that the problems that got us into this situation have miraculously disappeared but more of an acknowledgement that things had simply moved too far one way.

And while shareholders may be nursing sore heads and empty wallets, two things appear more certain. Firstly that the investment banking community is making money hand over fist; earning fat fees on the billions of new funds being raised. In stark contrast, the losers appear to be our major commercial banks, who have displayed lemming-like behaviour in denying capital to all but a handful of blue chip clients. Based on our discussions with directors and management alike, our main banks have a lot to answer for and the longer term damage that could be inflicted on them through the loss of future business should not be underestimated.

Table 1: New Issues

	FY08 Shares	**FY09 Shares**	**% Change**	**$ mill 08 NPAT (a)**	**$ mill 09 NPAT (f)**	**% Change**
Alumina	1,129,026,761	2,440,196,187	116.1	436.4	-150.0	n/a
APN	489,154,372	595,237,735	21.7	167.4	105.0	-37.3
Asciano	656,596,506	3,010,623,605	358.5	-182.1	-155.0	n/a
Billabong	207,437,563	252,007,759	21.5	176.4	162.5	-7.9
BlueScope	762,444,516	1,823,297,662	139.1	612.3	160.0	-73.9
Fairfax	1,513,622,490	2,351,955,725	55.4	386.9	209.0	-46.0
Fisher & Paykel App	284,608,907	725,939,975	155.1	54.2	34.0	-37.3
GPT	4,467,363,800	9,277,584,743	107.7	467.0	358.0	-23.3
Incitec	1,217,230,560	1,599,761,337	31.4	614.3	375.0	-38.9
Kagara	216,547,147	589,214,550	172.1	65.0	-63.0	n/a
Onesteel	878,712,920	1,325,811,294	50.9	315.0	332.0	+5.4
Primary Healthcare	371,225,650	430,748,277	16.0	7.6	106.0	>1,000
RioTinto	1,454,070,000	2,217,456,750	52.5	3,676.0	4,900.0	33.3
Santos	584,219,202	881,903,244	50.9	1,650.1	166.0	-89.9
Stockland	1,480,552,814	2,364,773,862	59.7	704.6	-1,561.0	n/a
STW	199,280,485	364,310,964	82.8	17.0	32.0	+88.2
Suncorp	955,528,252	1,257,377,460	31.6	561.0	390.0	-30.5
Transfield Services	198,063,552	413,281,383	108.7	82.2	83.0	+1.0
Transpacific	289,951,438	1,026,800,000	254.1	175.3	90.9	-48.2
Wesfarmers	658,508,406	1,005,125,230	52.6	1,050.0	1,750.0	+66.7
Westfield	1,942,202,837	2,276,448,850	17.2	3,460.3	1,886.0	-45.5

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So far the portfolio has weathered the storm particularly well. While some hits have been taken along the way, we are confident that there are many business franchises and management teams that will emerge from these difficult periods in much stronger shape.

REA Group (REA) added to the portfolio

It is only when one considers the significant part that employment, cars and housing have played in building old media's "rivers of gold" that one truly understands the threat that the online world brings. Anyone doubting the shift needs only to consider the growing influence of these un-invited new players. And in much the same way that seek.com.au has come to dominate the online employment space and carsales.com.au the online auto classifieds, so too has realestate.com.au cemented its hold on the online real estate section.

We too were caught off guard with the growing dominance of these online players. When SEEK listed on the exchange in April 2005, we certainly didn't appreciate the magnitude of the print-to-online shift that was under way. However, as we noted in our September 2008 quarterly report, the share market's dramatic decline provided investors with an opportunity to revisit some former high flyers. That we added SEEK to the portfolio back then at what we considered knock down prices also now applies to the REA Group ($4.75 entry price). Table 2 provides a snapshot of the group's climb from local obscurity to market dominance.

The group's key strength lies in its first mover advantage in building Australia's online market site of choice for real estate classifieds. From a standing start, the REA group's local online dominance is demonstrated by both the rise in the number of real estate paying subscribers and the annual revenue charged. Each agent that joins pays an annual subscription fee, providing them with unlimited access to list new properties. Agent numbers have grown from less than 1,500 with each paying about $200 per month in 2001, to the current level of 9,264 paying $926 per month. Additional revenue sources including website advertising and developer income makes up the balance of the group's income. While the Fairfax-owned domain.com.au portal is the group's nearest competitor, with a 25% market share, it lags the 65% market-leading position of realestate.com.au.

Table 2: REA Group Corporate History 1995-2009

Year	Event
1995	Business established with $24,000 of invested capital by joint founders Karl Sabljak and Martin Howell
1999	Listed in November as realestate.com.au Limited with a $6.0 million capital raising at 50 cents per share, giving the group a $20.8 million market capitalisation
1999	Shares hit a post listing high of $1.50 in December
2000	Reported losses hit $6.3 million
2001	Shares hit all time low of 5 cents per share September 2001
2001	Private placement to News Limited giving it a 40% interest
2001	Simon Baker appointed chief executive officer
2002	Group becomes operationally cash flow positive, subscribing paying agents passes 2,000 in number
2003	Macquarie Bank sells its 15.8% stake to Songpan Pty Ltd (The Ray White Group)
2003	Revenue doubles to $18 million, records first time full year net profit of $2.5 million
2004	Group acquires property listing website, property.com.au from RP Data in $9 million transaction, lifting subscriber paying agents numbers by 750 to 5,200
2005	Revenue exceeds $30 million, reported profits hit $8 million, shares trade above 1999 level
2005	Launches print publishing trial to complement online services / expands into New Zealand
2005	News Ltd bids $2.00 per share in takeover in August / offer raised to $2.50 in Oct
2005	Acquires UK property portal propertyfinder.com for $34 M in JV with News Ltd. Business revenues at $7 million, slight loss maker with 2,000 subscribing agents
2005	News Ltd full takeover offer fails, interest lifted to 58.6%
2006	Rights issue at $3.00 per share, raising $25 M
2006	Online visits to company websites exceed 5 million
2006	Partners with SKY Italia to acquire 90% of Italy's largest real estate website Casa.it for $15.9 M / split 59.4% (REA), SKY (30.6%). Founded in 1996, small profits, 2,800 subscribing agents servicing 60 million population, 15,000 estate agents
2007	Revenues exceed $107 million, net profit hits $15.1 million, core metric of subscribing paying agents jumps 6,298 to 17,011, shares hit all time peak of $7.49 in November
2007	REA acquires 51% interest in Albabaworld.com – Dubai's leading website for $1.2m
2008	CEO Baker reappointed, expands in UK via purchase of Sherlock Publications $12m
2008	Increases direct interest in Casa.it to 69.4% for $2.44m
2008	Group announces departure of CEO Baker / Appoints Greg Ellis as new CEO from previous role as marketing director Asia online services for Microsoft and 5 years at Sensis, 11 years at Telstra
2008	Ray White reduces stake to 11% with off market sale at $4.50 to News Ltd (60.7%)
2009	UK print business to close / UK online business under review

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As Table 3 highlights, this has given rise to some wonderful business metrics. Strong top line growth has flowed through to impressive operating profits and rising margins. But these numbers also include the group's loss making offshore operations. During 2008, these businesses lost a total of $15.4 million, impacting the group's bottom line by $8.8 million.

Table 3: REA Group Financial Snapshot

	$'M	2003	2004	2005	2006	2007	2008	2009 (e)
	Revenue	9.5	19.0	33.4	60.4	107.3	155.6	187.0
	Operating Margin (%)	12.6	14.2	19.5	24.8	21.9	23.5	26.4
	EBITDA	1.2	2.7	6.5	15.0	23.5	36.6	49.5
	EBITA	1.0	2.4	5.7	13.3	19.5	33.8	45.0
	NPAT	(1.5)	2.5	8.1	8.2	15.1	22.3	29.5
	Net Debt / (net cash)	(1.4)	(2.6)	(7.3)	(10.4)	(2.0)	(7.3)	(30.0)
	Market Capitalisation	24	87.2	154.5	483.7	756.2	557.6	758.7
	Enterprise Value	22.6	84.6	147.2	473.3	754.2	550.3	728.7
	Subcriber Paying Agents	3,173	5,207	6,414	10,713	17,011	22,478	22,100
Quant Screen	Earnings Yield (%)	4.4	2.8	3.9	2.8	2.6	6.1	6.2*
Quant Screen	ROCE (%)	934.5	27.9	49.4	21.9	23.5	31.4	40.0
Quant Screen	Cover ratio	(4.4)	13.2	13.9	7.1	7.9	9.0	9.0
	GOCF / EBITDA (%)	85	162	109	73	102	90	90
	Earnings per share (¢)	n/a	2.4	7.5	6.4	11.9	17.5	23.2**
	PER	n/a	34.2	19.2	59.4	49.9	25.0	25.7
	Share Price 30 June ($)	0.26	0.82	1.44	3.80	5.94	4.38	5.96
	Issued Capital	92.9	106.4	107.3	127.3	127.3	127.3	127.3

* The earnings yield is estimated at 10.0% excluding overseas losses
** The EPS is estimated at 35.0 cents excluding overseas losses

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Under new CEO Greg Ellis, such losses are now under review. Already the UK operations have been earmarked for a possible exit while the Italian business provides the group with the largest medium term upside. Not unlike the Australian market, the group's casa.it portal leads the Italian market with an estimated market share of 40%. With some 6,000 agents signed up of a total market estimated at 15,000, the signs are good for this emerging online market. During 2008, these operations lost $2.8 million, a figure that is now expected to exceed $6.0 million in 2009, as management ramps up marketing.

With no net debt, a renewed capital management focus and News Limited continuing to creep on the register, the REA Group is attractively priced. Excluding offshore losses and a market capitalisation approaching $760 million, we estimate the group is trading on a current earnings yield of 10%. The recent drop in share price has little to do with the business fundamentals, providing investors with a rare opportunity to part own an entrenched market-leading operator, trading at an attractive price.

Looking Out

On 12 June 2009, we dialled into a teleconference with JP Morgan's US economist Bruce Kasman, commenting on their current global economic views looking out.

Key points noted;

i. 4 – 6 quarters of positive US GDP growth, moving towards 4% during 2010
ii. Synchronised global growth
iii. US unemployment remaining high at around 8% into 2012
iv. Renewed deflation threat as core consumer price trends from high 1% to 0%
v. US Fed interest rate policy remaining unchanged in 2010

The argument put forward was of an economy moving out of recession, thus providing a foundation for growth but with sobering challenges remaining.

On the 5 key points;

The headline GDP growth number may come as a surprise to many, but it needs to be put into context of where we have been. More on that a little further on.

Synchronised global growth makes some sense. We know we have had a synchronized global recession. This resulted in unrivalled synchronized government intervention. Today, we have a somewhat synchronized recapitalisation of global balance sheets.

Continued high unemployment is a concern and seems counter-intuitive to the headline growth, as are falling core consumer prices, particularly in light of massive government intervention - we will explain this. And if points iii and iv hold true, then the US Federal Reserve is likely to keep rates on hold.

The arguments for points i and ii had two aspects.

Firstly, empirical evidence suggests that the worst elements of the credit crisis are abating. Central government policies have produced an important circuit breaker, which has seen credit markets working more effectively.

As they should, these markets are now differentiating between high quality credit and low quality credit, heralding a return to more normal conditions than that experienced over the past six months.

Even though deal flow normalcy has not yet returned, non-bank financing is working, and includes;

- ✓ Corporate bond markets
- ✓ Commercial paper markets
- ✓ Asset backed paper
- ✓ Equity markets (facilitating balance sheet repair)

Secondly, Kasman notes the behavioural changes.

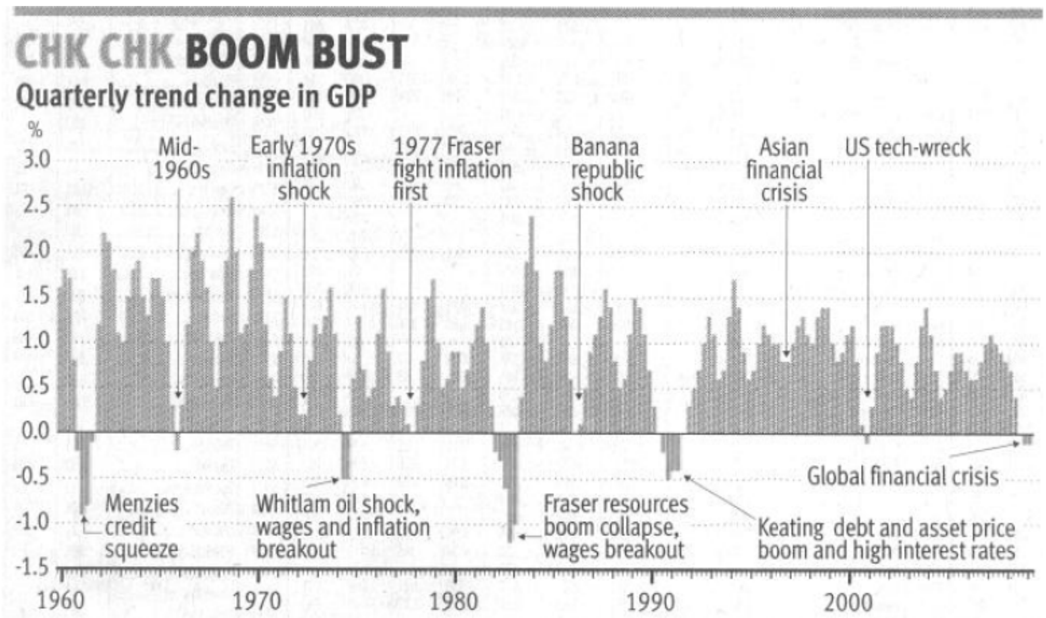
Consumers were rocked to their threadbare socks, initially by soaring energy prices and rising inflation. Throw in a depressing jobs market, a downward spiralling housing market, a free falling share market and finally, the fear of financial meltdown and it’s easy to envisage a return to a 1930s depression era. Not surprisingly, the consumer response was both rapid and magnified in nature. The fallout included;

- ✓ Consumer durable goods spending fell to its lowest point since WWII.
- ✓ Consumer housing spending fell to its lowest point since WWII.

The shift in business behaviour has been just as dramatic, as managers bunkered down, preparing for the fall out. Production and inventory levels fell to unsustainably low points. These levels were well below the supply levels normally experienced in a recessionary-type trading environment.

Today, it is fair to say that many of the market's worst fears have not manifested. Even the actions of consumers are now akin to a more normal recessionary response, evidenced by improving consumer confidence readings even while labour markets continue to deteriorate. Graph 3 illustrates Australia's skirt with recessions dating back to 1960, noting their regular occurrence.

Graph 3: Australia and Recessions 1960-2009



Source: The Australian, ABS

In short, while things may be bad, the reaction from businesses has been so swift that even servicing current demand levels would require a rise in both production and inventory levels.

This growth results in a positive feedback loop that we have spoken about in past newsletters. Kasman believes this loop will provide the necessary leverage to drive 4 – 6 quarters of positive growth and a US GDP rate of 4% in 2010. In his view, this alone could result in the best industrial production growth rates more than 20 years. However, somewhat sobering is Kasman's belief that this source of growth is really reflecting the consumer coming to grips with the situation rather than reflecting a return to robust growth, supporting strong job creation, we are likely to see more conflicting signals on the economy's health in the months ahead.

Here, Kasman dovetails a story of excess capacity and enormous slack in the system that will result in high unemployment for years to come and keep core consumer

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price growth low or flat. As a consequence, the prices of finished goods will remain weak and act as a source of disinflation that will see the US inflation rate trend from the mid to high one percent to a figure closer to zero.

Such outcomes are likely to result in the US Federal Reserve keeping interest rates on hold well into the back half of 2010.

Our own view on this subject has remained consistent and draws some parallels to that of Kasman's. We subscribed to the view that the levels of inventory drawdown where unsustainable and extreme. Even worse, extrapolation of these events led to scenarios that appeared highly unlikely.

That said, the deleveraging process that we now find ourselves in is of such a scale that a simple V-shaped recovery is highly unlikely.

Anecdotal evidence canvassed from a wide range of businesses would back the view that the priority of most managers is to now reduce debt levels to newly redefined levels of acceptability. For us this has resulted in several things.
The dilutive capital raisings we spoke about in our September 2008 quarterly newsletter are today's normal course of action

i. Generally, lower rates of earnings growth are now likely to follow
ii. Investors are likely to attribute lower earnings multiples to businesses.

Nevertheless, such uncertainly and confusion has provided attractive prices at which to invest. Not unlike the inventory example, when investor fear finally subsided, the situation of quality companies trading at knock down prices was never going to last for long, a statement we made clear in our newsletter.

Likewise, not all companies are dependent on debt to fuel growth. Rather, businesses with the ability to generate solid internal cash flows will remain, as ever, sought after investments.

Australian Governments and Debt

It is rather ironic that just when everyone else is looking to cut down debt, governments are heading in the other direction. As we outlined in our June 2008 quarterly newsletter under the title, "Governments–Perfecting the art of stealing", it was looking rather ominous that with revenue shortfalls a growing threat, that governments of all persuasions would look to make up the shortfall. So while the dead hand of governments to tax more is always a constant threat, the sheer size of the revenue hole has meant that large of chunks of new debt are now the only real viable funding alternative.

Putting aside the Federal Government's projected net debt position of $188 billion in four years' time, the situation facing the various state governments is just as confronting. From a combined net debt position of just $21 billion two years ago, budget papers now show this rising to $166 billion by 2012-13. So while businesses are tightening their belts and reducing their reliance on bank funding, state governments will be up to their necks in new debt. And with such a burden, it is already apparent that valuable assets will be offloaded and services outsourced from public to private hands. And down the track, don't be surprised to read that the real winners to emerge from this new era of conservatism will include all those new investors and business operators who get to share in the governments' own pursuit of deleveraging.

New website

Our website is new and improved with easy access to our library of newsletters.
Watch the two noteworthy interviews under items of interest.
www.selectorfund.com.au

COMPANIES VISITED DURING THE 4th QUARTER 2008-2009

April

SHV	Select Harvests management meeting	01/04/09
WOR	WorleyParsons site visit	08/04/09
PXS	Pharmaxis third quarter conference call	09/04/09
MND	Monadelphous Group management meeting	09/04/09
BOQ	Bank of Queensland management meeting	15/04/09
PLI	Peplin Inc management meeting	16/04/09
BRC	Brain Resource management meeting	20/04/09
SIP	Sigma Pharmaceuticals management meeting	21/04/09
ALL	Aristocrat Leisure annual meeting	21/04/09

May

MQG	Macquarie Group full year briefing	01/05/09
REA	REA Group management meeting	04/05/09
ORG	Origin Energy Macquarie conference	06/05/09
AGK	AGL Energy Macquarie conference	06/05/09
IRE	Iress Market Technologies Macquarie conference	06/05/09
IIN	iinet Macquarie conference	06/05/09
OSH	Oil Search Macquarie conference	06/05/09
CTX	Caltex Australia Macquarie conference	06/05/09
CPB	Campbell Brothers Macquarie conference	07/05/09

WBC	Westpac Banking Corporation Macquarie conference	07/05/09
QBE	QBE Insurance Group Macquarie conference	07/05/09
CPU	Computershare Macquarie conference	07/05/09
TAH	Tabcorp Holdings Macquarie conference	07/05/09
WOR	WorleyParsons Macquarie conference	07/05/09
FLT	Flight Centre Macquarie conference	07/05/09
FAN	Fantastic Furniture Macquarie conference	07/05/09
ARP	ARB Corporation Macquarie conference	07/05/09
AUW	Australian Wealth Management Macquarie conference	07/05/09
TLS	Telstra Corporation Macquarie conference	08/05/09
STO	Santos Macquarie conference	08/05/09
WDC	Westfield Group Macquarie conference	08/05/09
DJS	David Jones Macquarie conference	08/05/09
WOW	Woolworths Macquarie conference	08/05/09
NAN	Nanosonics management meeting	13/05/09
IGO	Independence Gold management meeting	13/05/09
PAN	Panoramic Resources management meeting	13/05/09
MBN	Mirabela Nickel management meeting	13/05/09
WSA	Western Areas management meeting	13/05/09
ROC	ROC Oil annual meeting	21/05/09
CXD	CathRx management meeting	22/05/09
PXS	Pharmaxis site visit	25/05/09
CPB	Campbell Brothers full year results briefing	26/05/09
ROC	ROC Oil open investor day	26/05/09
FPH	Fisher & Paykel Healthcare full year results briefing	26/05/09
CXD	CathRx site visit	28/05/09
TEL	Telecom Corporation of NZ investor open day	28/05/09

June

NMS	Neptune Marine Services management meeting	03/06/09
WES	Wesfarmers management meeting	04/06/09
DOW	Downer EDI investor day	10/06/09
COH	Cochlear site visit	16/06/09
RMD	Resmed site visit	16/06/09
IPD	Impedimed management visit	19/06/09
TSI	Transfield Services Infrastructure Fund management visit	29/06/09