Selector Fund Quarterly Newsletter

September 2011

In this quarterly edition we look at the macro impact on valuations, investor sentiment and retail investments. Cover shot. Retailers. Opportunity or paradigm shift?

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Dear Investor,

The quarterly newsletters are our way of explaining the investment rational that underpins the choices we make and the world that we see. We spend a considerable time articulating our thoughts with the aim that our investors are better informed. But at times it is better to just cut to the chase. In short, our share market is cheap. It is perhaps dangerous to be so blunt, because when it comes to market's, sometimes it's the things we don't know rather than the things we profess to understand that can take you by surprise.

Today, there is a lot to worry about. The US Government's finances are under considerable strain while the twenty seven countries in the European Union and the seventeen countries operating under the Euro currency are battling to keep things in check. Closer to home, our dependency on Asia and our specific reliance on Chinese demand remaining strong becomes even more paramount. Our two speed economy and a Government that is doing its level best to place further financial strain on individuals and businesses is also taking its toll.

We have a Reserve Bank that appears out of touch with the majority of small businesses, who are struggling with growing business costs and new competitive forces. Consumers have learnt the art of restraint, exercising caution at the retail checkout. Banks have a mountain of cash to dole out but demand is weak, while housing demand is on a steady retreat. Yes, on the surface, there is a lot to be concerned about, but everything has a price and today, as we will explain a little further on, investors are bailing out of the stock market and running into the relative safety of cash, even though company valuations and dividend yields on offer are trading on extremely attractive terms.

According to the latest Westpac-Melbourne Institute consumer sentiment survey, almost 40% of consumers now think that bank deposits are the best place for savings while the next best strategy to follow is paying down debt, followed by real estate and finally 7% think buying shares is the way to go.

In this quarter's newsletter we explore this current phenomenon in our lead article "Flight to safety – but at what cost". We follow this up by reviewing the Fund's current portfolio makeup, consider the case for and against share buy-backs, explain why a company's most important asset isn't even recorded in the accounts and consider the merits of retail stocks.

In a particularly challenging period which saw world stock markets suffer their worst quarterly result since the peak of the global financial crisis, the Fund delivered a gross performance in line with the local index, reflecting both the brutal and indiscriminate manner in which stocks have been handled.

To all our investors we trust that you find the report informative.

Regards
Tony Scenna
Corey Vincent

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Performance September 2011

For the quarter ending September 2011, the Fund delivered a gross negative return of 11.07% as compared the 11.28% fall in the All Ordinaries Accumulation Index.

Performance table since inception

% Returns	Fund % Gross	All Ords Index %	All Ords Acc Index %
3 months	-11.07	-12.66	-11.28
3 years	0.25	-4.21	0.02
Since inception compound pa	5.08	0.48	4.70

Top 10 September 2011*	Top 10 June 2011*
Blackmores	Campbell Brothers
Campbell Brothers	Cochlear
Flight Centre	Flight Centre
IOOF Holdings	IOOF Holdings
IRESS Market Technology	IRESS Market Technology
News Corporation Inc	News Corporation Inc
ResMed Inc	ResMed Inc.
SEEK	SIRTeX Medical
SIRTeX Medical	Whitehaven Coal
Whitehaven Coal	WorleyParsons
Top 10 = 67.69%	Top 10 = 67.8%

*Listed in alphabetical order

Selector runs a high conviction index unaware stock selection investment strategy with typically 15-25 stocks chosen for the Fund. As shown above, the Fund's top 10 positions usually represent the great majority of its equity exposure. Current and past portfolio composition has historically been very unlike that of your average run-of-the-mill "index hugger" fund manager. Our stock selection to this point has not included either retail banks or the large resource companies, RIO and BHP. Our goal remains to focus on truly differentiated broad cap stock selection rather than the closet index hugging portfolios offered by most large fund managers.

Performance attribution for the quarter

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Top 5 stock contributors	%	Top 5 stock detractors	%
Blackmores	0.84	IRESS Market Technology	-1.28
CathRX	0.24	Flight Centre	-1.27
ResMed Inc	0.21	Billabong International	-1.22
News Corporation Inc	0.08	Cochlear	-1.11
Woolworths	0.08	SIRTeX	-1.10

As we noted in our opening comments, the past quarter was a particularly tough period for investors to stomach. Obviously trying to make sense of events when they extend well beyond the normal, makes the task so much harder. In many ways, our investment approach that focuses on the individual businesses rather than the broader macro drivers should come to the fore during these periods, but as events have unfolded much of what has taken place has little to do with rational thought and more to do with fear.

That said we have confidence in the businesses that make up the portfolio and even more importantly, the majority of the company balance sheets are debt free while growth prospects are in the main, quite positive. Looking out beyond the current malaise, which we acknowledge many investors are struggling with, the valuations now on offer look historically cheap.

During the past quarter, the winners were few but did include healthcare businesses, notably complementary medicines provider Blackmores and sleep disordered breathing group ResMed. Both businesses are in the top ten of stocks held by the Fund and in each instance, management have set a very clear path for continued solid growth in earnings. A smaller position in cardiac catheter player CathRx also advanced during the quarter with our expectations that current negotiations with international operators to distribute their products is likely to be unveiled by the company during the December quarter.

On the negative side, businesses including IRESS, Flight Centre and SIRTeX retreated along with the general market despite business prospects remaining bright for all three. In the case of both Billabong and Cochlear, the Fund took decisive action during the quarter following company specific events. In terms of Billabong, we cut the Fund's position by half at $5.00 per share prior to the company's full year results. This proved fortuitous and while the Fund continues to hold a smaller position, we are reviewing both the business and industry implications. We provide more commentary later in the review.

As to Cochlear, a business the Fund has held since inception, we took the tough but correct decision to sell out of our holding completely during September at $60 per share following the company's voluntarily recall of its latest Nucleus cochlear implant. While the company will update investors at the forthcoming annual general meeting, our reading of events suggests the long term business franchise is strong enough to sustain this current hit. With the stock now travelling below $50 per share we took the decision to re-enter the stock with a small position post the end of quarter. ***SFM***

The flight to safety – but at what cost?

Gyrations in world financial markets have investors in a spin and many are now retreating to higher ground. It does beg the question – should they have been there in the first place? Unlike many asset classes, investing in a business carries considerable risk. On the flip side, as a part owner, a successful investment can also deliver wonderful returns. The key as we see it is not to avoid shares as an investment but to appreciate what is at stake. The notion that capital losses should be avoided is certainly a noble target to strive for but far from realistic in its pursuit. What is more critical is how many of these become permanent capital losses.

This is an important distinction because getting the timing wrong is easily done and more so when conditions are as treacherous as they currently are. However, irrespective of the price paid, avoiding a purchase in a business with poor investment qualities is a far more critical decision in our opinion. The market's recent downward path has many businesses now trading at what appear to be attractive valuations. In many respects, this has made the task of investing even harder for some. As any company disclaimer will highlight, past performance provides no indication of future returns and the same can be equally said of a business's share valuation.

Today, this has been made all the more difficult with a number of structural issues at play. The take up of online technology, a surging Australian dollar and our variable economy has exposed many industries and traditional business models. With that as a back drop, simply buying a business because it trades on a low price to earnings (PER) multiple or an attractive yield is a strategy that does not sit comfortably with us.

Table 1 highlights a growing list of businesses trading on single digit PER's and in some cases double digit dividend yields, perhaps best illustrating the current investment environment. The difficulty as we have noted, is that while many businesses are now trading at historically very attractive levels, the jury is well and truly out when it comes to assessing that in the context of future earnings.

Long established companies including Fairfax Media, Perpetual and newer listed players like Harvey Norman Holdings are all grappling with their respective business models. The adoption of online technologies has Fairfax's traditional print business badly exposed while Harvey Norman concedes that consumers are now far more prudent with their spending and as a result more informed. Financial market operators like Perpetual have fared little better, as volatile markets and staff departures have seen investors exit the market, thereby placing strains on fee income generation.

Table 1.

Company	Share Price $	PER (x) 2011	Yield % 2011
Myer	2.06	7.9	10.5
QBE Insurance	12.62	8.3	10.2
Tatts Group	2.19	9.8	9.8
Perpetual	20.97	11.6	9.6
David Jones	2.98	9.3	9.4
Telstra	3.10	10.9	9.0
Billabong International	3.34	7.1	8.7
OneSteel	1.25	6.5	8.0
Fleetwood Corp	11.25	12.2	7.8
Commonwealth Bank	45.16	10.9	7.5
AMP	3.85	10.3	7.5
Westpac	20.48	9.7	7.2
Harvey Norman	2.14	8.7	6.2
CSR	2.35	10.0	6.1
ASX	29.85	14.9	6.0
DuluxGroup	2.47	11.6	6.0
JB Hi-fi	15.09	11.2	5.6
Wesfarmers	31.61	17.3	5.0
Challenger	4.25	8.3	4.1
Fairfax Media	0.81	6.7	3.4
BHP Billiton	34.78	8.7	2.7

** As at 29 September 2011 & ranked in terms of yield*

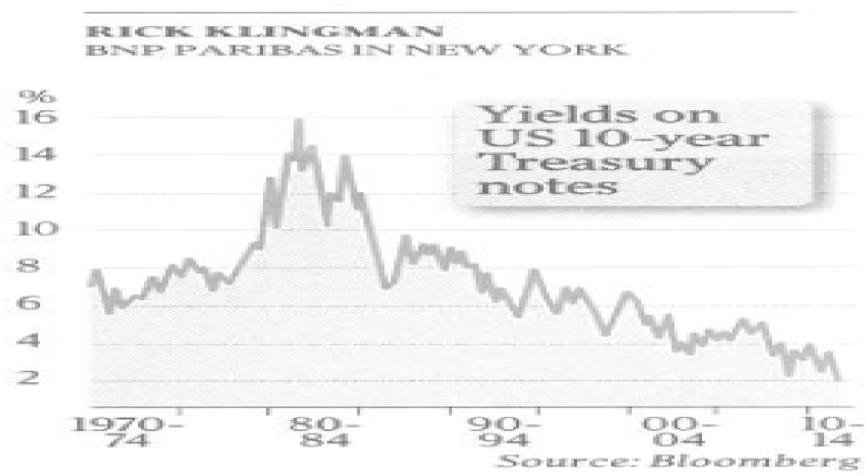
Generally speaking investors can cope with change, however, the events of recent times, both here and abroad, has shaken confidence to the point where the real risk may lie in those retreating to higher ground. In most cases, this has resulted in a dash for cash or other annuity type investments.

During September the US Government sold $US21 billion of benchmark 10-year notes at the lowest yield on record, at just 2%. Since then the yields have fallen below this level, trading at 1.72%, while 30-year bonds were yielding 2.98%. As **Graph 1** illustrates, US 10-year treasury notes having peaked at 16% during the early eighties have continued their downward trend to current levels.

Today, investors are betting that rates will, at best, remain at current levels for the foreseeable future. In our opinion, this is a bet fraught with considerable capital risk. Investors who are now seeking shelter in bond type investments at historically low yields may rue their decision.

Equally, businesses who operate high quality operations and enjoy strong financial metrics will embrace the current low interest environment as an opportune time to expand and lock in relatively cheap finance costs.

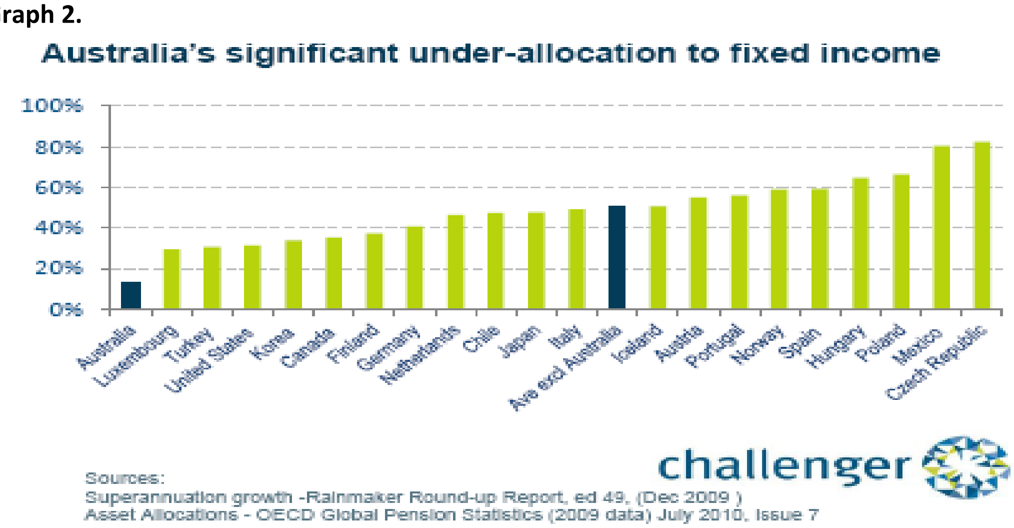
Graph 1.



The so called equity risk premium - the price demanded by investors to buy shares rather than bonds – is at extreme levels. As **Table 1** illustrates, dividend yields on stocks are much higher than bond yields as investors have raced for safety. On almost every metric, be that PER's or stock yields the markets are pricing in the worst.

Listed financial services group Challenger, has cleverly played on investor concerns, promoting the shift from riskier asset classes including shares to guaranteed income products. As Graph 2 highlights, Challenger's analysis of the local superannuation market notes that fixed income type investments makes up less than 13% of the current $1.4 trillion market, while other OECD countries that includes the United States, have an average allocation of 48% dedicated to this asset class. Furthermore, Challenger argues that this shift to income products is structural in nature driven by an ageing population and a desire to protect capital.

Graph 2.



Graph 3.

During the recent full year results update, Challenger's organic retail annuity sales rose 56% to $1.46 billion, driven in large part by the ongoing equity market volatility. CEO Dominic Stevens expects annuity sales to continue to grow noting that "while Challenger's annuity sales have already grown by an annual compound rate of 33% since 2006, we believe we're still at the early stages of a fundamental change in the Australian retirement savings market. To match expected demand we have grown our distribution team and are building our consumer brand through a national advertising campaign which appears to be resonating strongly with retirees. For 2012 we're targeting 25% retail annuity sales growth, 10% net retail book growth and a record $430 million lift in cash earnings, up 7% for the life company."

The shift to annuity type investments by investors is certainly understandable and in the context of an ageing population a sensible course to take. That said, annuities are underpinned by a diversified portfolio of income producing assets, ranging from the most liquid, being cash and AAA rated securities, right through to B rated assets. These assets are not entirely without risk and investors should be mindful that in pursuing a guaranteed income stream the type of assets that support the payments are well understood.

The surge in annuity sales also highlights what investors are currently seeking – certainty. Unfortunately running from one asset class to seek shelter in another does not necessarily guarantee long term success or certainly. ***SFM***

A 200 year prospective on the US market

At extreme times in history, extreme views seem to manifest themselves. Diverging themes seem to pop up everywhere and weary investors are left none the wiser. One view that has recently surfaced on the news wire *(source The Australian September 2011)* is that of financial historian Professor Sylla from New York University's Stern School of Business.

Graph 4.

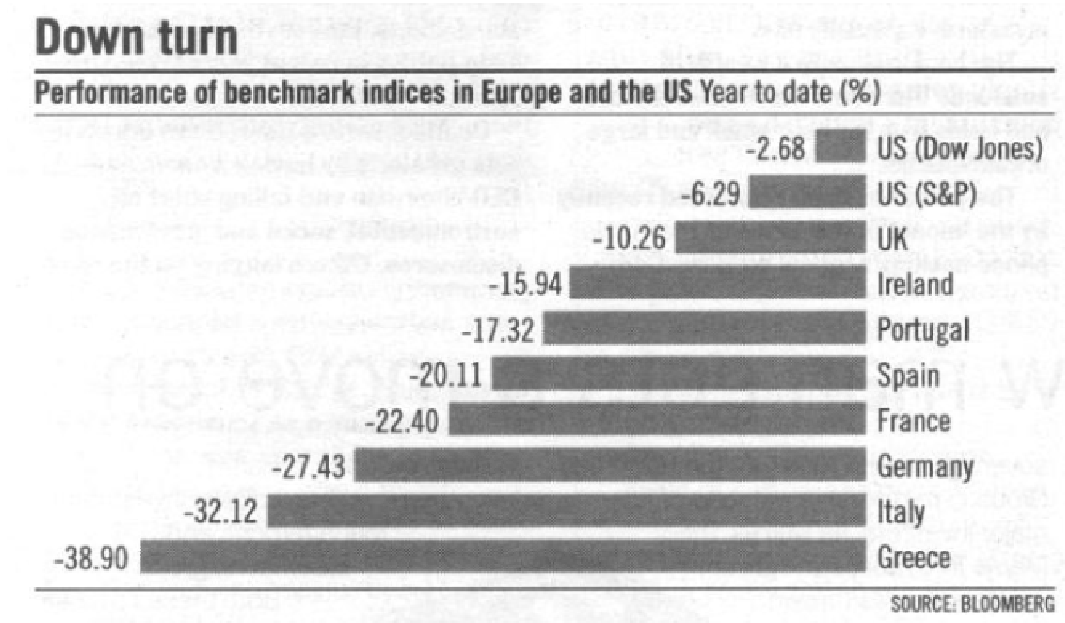
The study of the US market extends back to 1790, with the annual returns depicted in **Graph 4**. Rather than a commentator expressing a point of view, Professor Sylla used 10-year averages of annual market returns, including dividends and adjusted for inflation. The data showed that US stocks have risen and fallen in surprisingly consistent waves for more than 200 years.

Importantly, when 10-year average annual returns dip below 5 per cent and in fact turn negative, as was the case in 2008-09, markets tend to bottom out and begin recovering. Similarly when investors get overconfident, markets top out when average returns exceed 15 per cent.

His analysis is not suggesting that stocks will rise by the 6.5 per cent average annual returns that the historical data would indicate but rather that this could be the average achieved. Professor Syall noted "There is a lot of excessive short-term thinking about the stock market. In the 1980's, it looked terrible with those low returns, but I tell my students that wasn't such a bad time to buy stocks. My guess is that even if we had a couple more years of bouncing around, 2013 to 2022 would be much better."

Apart from the Greek share market, other major European markets have yet to hit 2008 levels. That said, the hit to confidence has been substantial with major markets including the German and French markets down over twenty percent year to date. The 17 countries that may up the Euro zone are grappling with an issue that won't go away that easily. As our Reserve Bank Governor Glenn Stevens noted, "the seeds of Europe's current sovereign debt woes had been sown last decade when major economies such as Germany and France were allowed to flout the EU's budgetary rules."

Graph 5.



** As at 7 September 2011*

The fallout from the 2008 crisis remains too fresh in investors' minds. Today, investors require both conviction and courage to put those difficulties into some sensible context. The shift out of assets classes now deemed risky may make perfect sense but not when fear and panic are the chief drivers of such actions. As we noted in our opening line, investors are once again running to the exits, seeking comfort in guaranteed annuity products and cash. In the process, companies that have been caught up in the maelstrom of uncertainty have had their prices impacted to a level out of proportion to the business downside. The events of 2011 appear to be a mini repeat of those that took place in 2008 and as such keeping things in some perspective will pay dividends in the long run. ***SFM***

Intangible assets – people

People are the life blood of a business but their value appears nowhere on a company's balance sheet. Yet if you speak to any successful business person and ask what are the secrets to their success, sitting high on the list are the executive and management teams who make it all happen.

When we look at the merits of investing in any business, we consider four criteria's. In crude terms they include, the business, the financials, capital management record and people. Some of these things can be easily measured while others require an understanding of what makes a business tick. Over the past quarter we caught up with a number of management teams and a common theme amongst the more successful businesses is the role that staff plays.

Of particular note the Monadelphous Group, WorleyParsons, Data#3 and Flight Centre all have a track record of delivering long term success in their respective fields. Collectively these businesses employ some 53,250 people, operate in service orientated fields and rely on a satisfied customer to generate ongoing revenue. Generally speaking business margins are hard fought and employee costs the businesses largest impost.

Table 2.

	2005	2006	2007	2008	2009	2010	2011
Monadelphous							
Sales ($m)	391	532	959	954	1,123	1,275	1,444
EBIT ($m)	23.8	41.4	83.7	96.7	101.1	112.6	128.9
Margin (%)	6.1	7.8	8.7	10.1	9.0	8.8	8.9
UNPAT ($m)*	16.7	29.4	60.4	69.5	74.2	83.2	95.1
WorleyParsons							
Sales ($m)	1,248	2,397	3,478	4,605	5,795	5,060	5,605
EBIT ($m)	93.8	199.6	319.1	483.5	561.2	373.0	442.7
Margin (%)	7.5	8.3	9.2	10.5	9.7	7.4	7.9
UNPAT ($m)*	62.3	140.0	224.8	343.9	390.5	291.1	398.5
Data#3							
Sales ($m)	196.5	239.0	284.7	362.9	529.7	598.6	696.2
EBIT ($m)	5.7	7.8	9.9	12.1	13.4	15.2	20.3
Margin (%)	2.9	3.3	3.5	3.3	2.5	2.5	2.9
UNPAT ($m)*	4.1	5.7	7.2	9.1	9.8	10.9	15.0
Flight Centre							
Sales ($m)	871.1	973.7	1,122	1,408	1,474	1,521	1,633
EBIT ($m)	106.3	111.1	161.3	200.3	89.0	206.1	236.0
Margin (%)	12.2	11.4	14.4	14.2	6.0	13.6	14.5
UNPAT ($m)*	76.9	79.9	120.8	143.2	97.6	139.9	171.9

** UNPAT = Underlying net profit after tax*

The Fund has an investment in all but one of these, Monadelphous, a decision that we unfortunately regret in hindsight. As **Table 2** highlights, despite unsettled business conditions, each has continued to deliver higher sales and growing profits over the past six years. Apart from WorleyParsons, who issued new shares as part of an acquisition in 2006, all of the growth during this period has been funded from internally generated cash flows, quite a rare feat considering the massive equity recapitalisations that took place post the 2008 financial crisis.

The point we wish to make here is the importance of having alignment. In a rapidly converging world, alignment of interest is crucial for building success. As an example, Qantas is at loggerheads with staff and the long term danger to both the business brand and employee morale is obvious. Similarly, companies that reward executives with inflated bonuses at the expense of long serving staff is likely to lead to serious discord. We seek alignment between executives, staff and shareholders in any investment where serious consideration is given. If we can see alignment, it may not protect us from investment losses but from our experience the chances of failure would have been largely reduced. ***SFM***

When company buy-backs may sense

Go back thirty years and investors wouldn't be necessarily aware of them, fast forward and today, share buy-backs have become common place. While the intentions of a buy-back are sound, there have been many occasions where shareholders have suffered at the hands of a poorly thought out strategy and sold by management as a capital management initiative. In our September 2010 quarterly newsletter titled "Understanding what your business is worth", Warren Buffett picked up on this point in the 2009 Berkshire Hathaway Inc. annual report commentary to shareholders. In one section headed "An Inconvenient Truth", Buffett zeroed in on the group's own distaste in issuing shares to complete mergers,

"Charlie and I enjoy issuing Berkshire stock as much as we relish prepping for a colonoscopy. The reason for our distaste is simple, if we wouldn't dream of selling Berkshire in its entirety at the current market price, why in the world should we sell a significant part of the company at the same inadequate price by issuing our stock in a merger?"

The same can be said of a company that embarks on buying back its shares and the tools it uses to enact it. Too often, the motives for undertaking a buy-back are to support a share price that has weakened in value, often with the use of debt. On other occasions, management in their wisdom, see fit to pay top dollar when flush with cash. Ideally buy-backs only make sense when the shares are trading well below a company's intrinsic value. While determining what constitutes a company's intrinsic value is a moving target, unless management have a sensible and clear understanding of that value, spending good money to buy more may not be a smart move.

Two examples highlighting divergent motives for buying back stock include, Rio Tinto and News Corporation - a stock the Fund does own. In the case of Rio Tinto, having stubbed its toe badly during 2008, the company embarked on a very dilutive capital raising during 2009 at $28.29 per share. Today with record metal prices and a share price approaching $65.00, Rio is undertaking a $7.0 billion capital return programme. Flush with cash, is this a sensible policy or one driven by market pressure? Perhaps the one redeeming feature is the use of cash rather than debt in undertaking the buy-back.

In total contrast, News Corporation has avoided the need to issue scrip in recent times, having learnt from its near death experience with bankers during the early 1990's. Rather, the group has avoided calling on banks for capital, preferring to use long dated public debt, with expiry periods stretching out to 2096 on interest rates averaging 6.8% per annum. The higher cost of debt is offset with the knowledge that the funds can't be pulled any time soon. At balance date

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June 2011, News Corp's gross debt stood at $US15.5 billion while its cash balance totalled $US12.7 billion. In essence, the company's net debt position stood at just $US2.8 billion but with cash earning next to zero in the bank, the company's cash is providing little value to shareholders.

And unlike Rio Tinto, News Corp shares have barely moved from 2009 levels of $16.00 per share, despite earnings before interest and tax (EBIT) advancing from $US3.5 billion to $US4.9 billion over the period. Following its recent decision to withdraw its takeover offer for the balance of British Sky Broadcasting Group PLC (BSkyB) shares outstanding, the board has announced an acceleration of its current buy-back program to $US5.0 billion. This compares to the stock's current market capitalisation of $US43.5 billion. On this score, we believe management are sensibly deploying their excess cash to buy-back shares trading well below its intrinsic value.

Today, companies in the US Standard & Poor's 500-stock index have a combined $US976 billion in cash and short-term investments on hand, the highest level in history. In August, 198 US companies authorised buy-backs of shares, the highest monthly total since February 2008, putting calendar 2011 as the third busiest buy-back year on record. Even Warren Buffett who has previously argued against buy-backs, as motivated by management "to pump or support the stock price", announced last month its intention to repurchase shares in his own Berkshire Hathaway, but only up to a valuation of ten per cent about its stated book value.

When done for the right financial and commercial reasons, buy-backs are a sensible strategy for shareholders who remain on board, as they end up enjoying a larger proportional stake in the company's future earnings. ***SFM***

Retail stocks on the nose

Everyone loves a bargain it seems, but not when the bargain is the business. We have been told that our love affair for shopping is on the wane. Consumers have become prudent, prepared to save more and as a result spend less. Graph 5 appears to confirm this trend.

Tracked back to 1999, the relationship between consumer income and spending has flipped around since 2009, with consumers now far more cautious in their habits. The internet and the take up of online trading has been targeted as an obvious reason for the slowdown, along with a growing nervousness among consumers that things may just get a whole lot tougher in the period ahead. Despite the Reserve Bank of Australia telling us that an economic boom is upon us, it seems that consumers aren't prepared to bank that just yet.

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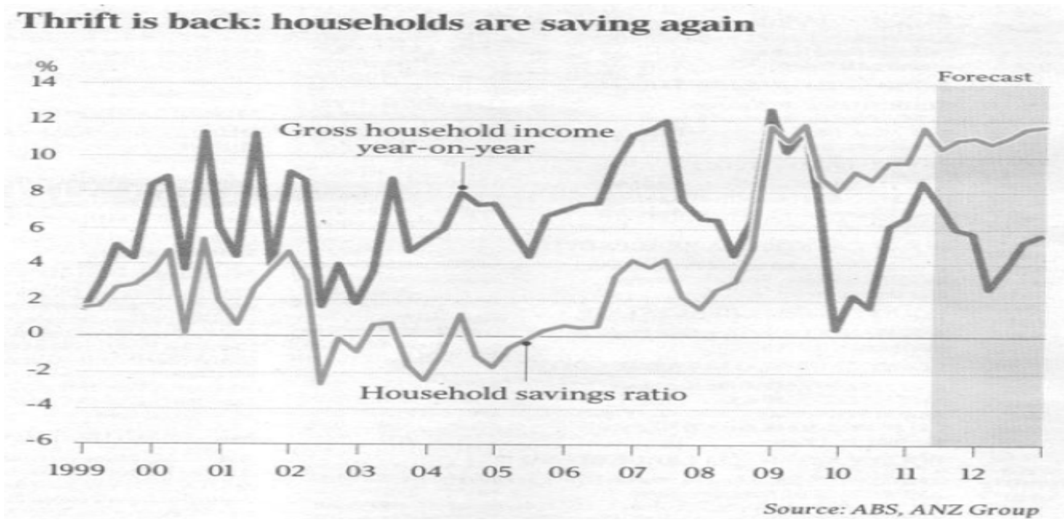
Graph 5.



Our take on things is that the discretionary dollar has been whittled away from the consumer, as rising living costs places further strain on family budgets. So while the chart above may indicate a rising savings ratio, we think it reflects money being set aside to meet future commitments. Obviously a positive by-product is a propensity for consumers to pay for goods now rather than using credit or delaying the purchase altogether. **Table 3** outlines some well know retailers and some financial metrics that tell a story.

Table 3.

	Share Price $	Market Cap $m	NPAT FY11 $m	Net Debt $m	Fixed Cover Ratio *	Free Cash Flow $m **	PER 2011 (x)	Yield 2011 (%)	Buyout (%) ***
Myer	2.06	1,177	159.6	382	2.0	66.4	7.9	10.4	16.7
David Jones	2.98	1,460	168.1	120	2.3	101.0	9.3	9.4	15.6
Kathmandu	1.75	440	39.1	42.9	2.5	27.9	11.3	4.5	13.1
Billabong	3.34	825	119.1	468	2.1	-242.6	7.1	8.7	12.1
OrotonGroup	7.80	319	24.8	9.2	2.7	17.1	12.9	6.4	11.0
Super Retail Group	5.97	776	55.6	73.5	1.8	24.5	14.0	4.9	10.3
The Reject Shop	9.37	246	16.2	39.3	1.4	1.0	13.6	3.3	10.1

Table Ranked in order of Buyout ratio
* Fixed cover ratio = earnings before interest, tax, operating leases / net interest expense + operating lease payments
** Free cash flow = Operating cash flow – capital expenditure
*** Buyout = earnings before interest, tax / market capitalisation + debt - cash

But the numbers alone do not tell the full story. Simply comparing the PER or yield of a company may lead the investor to form a potentially wrong view of a business. From our vantage point, the traditional department store retailers David Jones and Myer appear to be in a world of pain right now, while the smaller niche operating chains look to be faring a lot better. In many ways the comments from OrotonGroup CEO Sally Macdonald really hits the mark for us;

"Not all retail should be painted with the same brush. We are not finding conditions any tougher than they have been for the past three years. Zara and Apple are also doing great. You cannot go to market with the same things you did five years ago and expect to gain traction with consumers. You have to change and move on. We are always looking at what we can do better"

The point is valid but also highlights that retailers are subject to fashion trends. The larger department stores are aiming to avoid playing the fashion stakes by providing an all encompassing retail offer, but in trying to be all things to all shoppers they run the risk of remaining relevant only on price. In stark contrast, operators like OrotonGroup, Kathmandu and Billabong have hitched their wagon to specific product offerings. They tell a story and build a brand around the image they create. The strategy isn't full proof but the chances of creating long term brand loyalty makes a lot more sense than the department store offering.

Over the past month a number of these businesses have announced their profit results with mixed success. The larger players, Myer and David Jones reported disappointing sales and profit numbers, while Kathmandu in particular, delivered both strong top line and bottom line growth.

The company's focus on providing outdoor apparel and equipment at affordable prices looks to be a winning formula. The group now operates 111 stores throughout Australia and New Zealand, with group sales of NZ$306 million, earnings before interest and tax (EBIT) of NZ$64 million and a bottom line profit of NZ$39.1 million up from NZ$25.2 million during 2010. In the near term, management is targeting 150 stores, while aiming to lift Australian sales penetration to a similar level to that achieved in New Zealand.

This would appear to be a tall order considering the extraordinary local success the group has achieved to date, as reflected in the following numbers. During 2010, Kathmandu's New Zealand store footprint achieved sales of $NZ94.3 million, equivalent to NZ$23.41 per capita population. In contrast, Australian operations delivered NZ$142 million in sales, or NZ$6.86 per capita population. Even a partial success of this strategy would back management's view that sales could lift by over NZ$100 million under the existing store footprint, a rise of over 70% from its current Australian sales base.

The Kathmandu investment story is a very good one. Similarly the OrotonGroup has defied the retail downturn, with sales up 12% to $164 million and EBIT rising 14% to $36.5 million for the 2011 year. With management continuing to invest in new stores both locally and in Asia, investors should measure the group's ongoing success in years not months. That said, the Oroton brand enjoys excellent market presence, led by an experienced management team with CEO Macdonald at the helm.

While we are supportive of retail businesses that can build brand while maintaining intellectual property ownership, there is the risk that a brand fades. Think of Colorado, Brashs and Harris Scarfe to name but a few. In most cases, debt plays a large part in the demise of any retail chain. In **Table 3** we highlight debt in two forms. There is the straight forward bank debt as depicted in the net debt column, a term most investors would be familiar with. An equally important number is the fixed cover ratio. This ratio considers how many times the group's annual operating leases or rental payments are covered by group earnings. In retail, a number greater than two would be preferred although there are times when one-off events, like the Queensland floods, can distort the numbers as was the case for The Reject Shop.

For Billabong International, a very low PER of 7.1 and a highly attractive dividend yield of 8.7% also fails to tell the full story. The group's transition from a pure wholesale provider of action sports to a more vertically integrated model that includes retail ownership has most investors asking whether the model will work.

It is a little too early to answer that question but the debt the company has taken on board to fulfil its strategy and the tough retail conditions in both the local and US market, has made things a little tight for our likening. The share price has virtually halved since the group announced a disappointing set of earnings numbers in early August, with the shares now trading at close to an all time low following its listing in 2000.

As an overview, the strength of the Australian dollar has arguably highlighted the local retail sector to offshore players. At the same time, the acceptance of the internet as a tool to purchase goods has bought these offshore players closer to the consumers. So while the consumer may be suffering from a short term dip in demand, international competition is increasingly arriving into the sector, typified by the Sydney retail launch of Spanish fashion group ZARA International during the past quarter. As such, these developments suggest the issues facing the retail sector are as much structural as cyclical.

While we have only touched on a few issues, the tough prevailing conditions in retail are having their effect on investor expectations. With retail share prices down and yields on the rise, most would agree that value is on offer. For our part, the Fund has a small holding in Billabong but if tempted our interest would certainly lie in considering the specialty retailers including OrotonGroup and Kathmandu in particular, while giving the bigger department stores a wide berth. ***SFM***

Company visit diary September Quarter 2011

July

n/a	Costco site visit	05/07/11
PXS	Pharmaxis Q4 conference call	21/07/11
DTL	Data#3 management meeting	22/07/11
ORG	Origin Energy conference call	28/07/11

August

NVT	Navitas FY11 results presentation conference call	02/08/11
n/a	Jim Rodgers hard & soft commodities presentation	03/08/11
RMD	ResMed FY11 results presentation	05/08/11
FXL	Flexigroup FY11 results presentation	08/08/11
COH	Cochlear FY11 results presentation	09/08/11
COF	Coffey International FY11 results presentation	10/08/11
CPU	Computershare FY11 results presentation conference call	10/08/11
NWS	News Corp FY11 results presentation conference call	11/08/11
TLS	Telstra FY11 results presentation conference call	11/08/11
PXS	Pharmaxis management meeting	12/08/11
CRZ	Carsales.com FY11 results presentation conference call	16/08/11
CSL	CSL FY11 results presentation conference call	17/08/11
BKL	Blackmores FY11 results presentation conference call	18/08/11
REA	REA Group FY11 results presentation conference call	18/08/11
BBG	Billabong International FY11 results presentation conference call	19/08/11
PTM	Platinum Asset Management FY11 results presentation	19/08/11
DTL	Data#3 FY11 results presentation conference call	22/08/11
ORG	Origin Energy FY11 results presentation	23/08/11
SEK	SEEK FY11 results presentation conference call	23/08/11
FLT	Flight Centre FY11 results presentation conference call	23/08/11
MND	Monadelphous Group FY11 results presentation conference call	23/08/11
WOR	WorleyParsons FY11 results presentation conference call	24/08/11
IRE	IRESS Market Technologies FY11 results presentation	25/08/11
MAP	MAp Group FY11 results presentation conference call	25/08/11
CWN	Crown FY11 results presentation conference call	25/08/11
PPT	Perpetual FY11 results presentation conference call	26/08/11
WOW	Woolworths Site visit FY11FY11 results presentation	26/08/11
BKL	Blackmores management meeting	26/08/11
IFL	IOOF results FY11 results presentation conference call	26/08/11
BBG	Billabong International management meeting	31/08/11

September

CBP	Carbon Polymers management meeting	01/09/11
PXS	Pharmaxis site visit	02/09/11
UBI	Universal Biosensors management meeting	06/09/11

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WCB	Warrnambool Cheese & Butter Factory FY11 results presentation	06/09/11
DTL	Data#3 management meeting	07/09/11
IRE	IRESS Market Technology management meeting	12/09/11
COH	Cochlear product recall conference call	12/09/11
KMD	Kathmandu FY11 results presentation conference call	21/09/11
CXD	CathRx management meeting	21/09/11
KZL	Kagara strategy day conference call	21/09/11
BKL	Brickworks FY11 results presentation	22/09/11

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