Selector Aust Equities Ex 50 Fund

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In this quarterly edition we review performance and attribution. We review and share some of our macro thoughts on energy, interest rates and bank regulation. Finally we focus on health insurance specialist NIB. Photo: An ACT Fire and Rescue team.

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About Selector

We are a boutique fund manager and we have a combined experience of over 60 years. We believe in long term wealth creation and building lasting relationships with our investors.

Our focus is stock selection. Our funds are high conviction, concentrated and index unaware. As a result we have low turnover and produce tax effective returns.

First we identify the best business franchises with the best management teams. Then we focus on valuations.

When we arrive at work each day we are reminded that;

“The art of successful investment is the patient investor taking money from the impatient investor”.

Our fund is open to new subscriptions. Please forward to us contact details if you would like future newsletters to be emailed to family, friends or business

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Dear Investor,

This time last year the world was in turmoil. Europe appeared beyond repair and influential investment commentators including Alan Kohler had given up on the market, noting the dangerous conditions that investors faced. This gloom was reflected in the local share market's fall of 15.2% for calendar year 2011. Even the Reserve Bank, having badly misjudged the weaker economic undercurrents, changed tack and cut cash rates to 4.25% by year end.

Twelve months on, European disaster has been averted for the time being, markets have moved forward strongly and local cash rates now sit at 3.00%. It's little wonder that investors are confused, while others cling to the aftermath of events thus passed. In such an environment, an investor's natural inclination is to do nothing and sit in cash and this is precisely what the vast majority have chosen to do. There is nothing wrong with this strategy, but many do so, not because of logic but for fear of loss.

The good news is these are exactly the type of conditions that present great investment opportunities. During the course of the year we identified, invested in and wrote about a number of these in our quarterly newsletters. It hasn't all been plain sailing but our confidence in both the chosen businesses and the management teams have been largely rewarded with rising profits and higher market capitalisations.

As we look out into 2013, investors are once again faced with some economic dilemmas. Will the US economy avoid its "fiscal cliff" moment? Will Australia survive the worst of the mining downturn and maintain its impressive growth profile of recent years? Will Europe agree to make the changes necessary and actually implement them? Will China maintain its eye popping growth rates and avoid its own property bubble?

We don't profess to know how these issues will pan out, however we are prepared to make some general observations as outlined in our lead article this quarter. We also profile another investment holding, health insurer NIB Holdings and highlight what happens when a company tells shareholders what they don't want to hear. But above all we will continue to seek businesses and management teams that are worth backing, even when the noise of the market suggests you do otherwise.

Finally, during the past quarter and over the 2012 calendar year the Fund outperformed the general market, delivering gross positive returns of **13.25% and 38.90%** respectively, as compared to the All Ordinaries Accumulation Index returns of **6.78% and 18.84%** over the same periods. We are pleased with these results considering the particularly challenging conditions that prevailed and thank you for your ongoing interest.

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

Regards
Tony Scenna
Corey Vincent

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The Power of Technology

An article that appeared in The Weekend Australian Magazine on 25 November titled "Take your tablets" Josh Glancy, brings into sharp focus the power of technology and children's ability to embrace all things new. It also illustrates how technology can go a long way in reducing the economic barriers that stifle entrepreneurship in under privileged nations.

"Until recently, life in Wonchi, Ethiopia, had barely changed for centuries. The 100 or so people in the village, 80km from Addis Ababa, lived almost entirely without technology. They had no school and no teachers. No one could read or write and most of the children had never seen a printed word. All this changed earlier this year when Nicholas Negroponte's trucks arrived, bringing Motorola Xoom tablets for every child aged between 4 and 14.

The tablets were programmed in English, a language they had never heard, and were loaded with up to 1,000 apps, including children's audio books, subtitled cartoons and a host of letter and word games. Negroponte, an academic and director at Motorola, sent the world of digital education into overdrive when he described the project's initial findings. Within four minutes, one kid opened one of the boxes, found the on-off switch and powered it up. Within five days, they were using 47 apps per child. Within two weeks, they were singing ABC songs in the village, and within five months, they had hacked the Android operating system." ***SFM***

Performance December 2012

For the quarter ending December 2012, the Fund delivered a gross positive return of **13.25%** as compared with the **6.78%** rise in the All Ordinaries Accumulation Index.

Performance table since inception

% Returns	Fund Gross Return %	All Ords Index %	All Ords Acc Index %
3 months	+13.25	+5.86	+6.78
1 Year	+38.90	+13.46	+18.84
3 years	+3.84	-1.51	+2.83
Since inception compound pa	+8.76	+2.11	+6.45

Top 10 December 2012*	Top 10 September 2012*
ARB Corporation	ARB Corporation
Blackmores	Blackmores
Flexigroup	Carsales
Flight Centre	Flexigroup
IOOF Holdings	Flight Centre
IRESS	IOOF Holdings
ResMed Inc.	IRESS
SEEK	ResMed Inc.
SIRTeX Medical	SEEK
Super Retail Group	SIRTeX Medical
Top 10 = 54.85%	Top 10 = 51.61%

*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.

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Performance attribution for the quarter

Top 5 stock contributors	%	Top 5 stock detractors	%
SIRTeX Medical	+2.99	Carsales	-0.21
Jumbo Interactive	+1.84	Fleetwood	-0.04
IOOF	+1.26	Austin Engineering	+0.06
Flexigroup	+1.12	MyState	+0.06
Super Retail Group	+1.01	James Hardie	+0.09

World Stock Market Performances 2012

As we noted in our opening comments of this quarterly newsletter, investors entered 2012 with many commentators warning of the dangers ahead. Suffice to say that investors who chose to wait for calmer waters may look back with some regret as **Table 1** highlights below. Across the board rises in the majority of world stock markets during 2012 caught many off guard, illustrating the importance of seeking opportunities and investing even when the overwhelming view is to otherwise.

Table 1: World stock market performances during 2012

World Stock Markets	31 Dec 2011	31 Dec 2012	% change
Greece Athens General	680.42	905.23	+33.0
Germany DAX	5,898.35	7,612.39	+29.1
India Nifty	4,646.25	5,905.10	+27.1
Japan Nikkei 225	8,455.35	10,395.18	+22.9
Hong Kong Hang Seng	18,434.39	22,584.44	+22.5
Singapore STI Straits Times	2,646.35	3,167.08	+19.7
Mexico Mex	37,185.73	43,721.93	+17.6
US Nasdaq	2,605.15	3,019.51	+15.9
Argentina Merval	2,462.63	2,854.29	+15.9
France CAC	3,159.81	3,641.07	+15.2
Australian ASX 300	4,066.18	4,626.28	+13.7
US S&P 500	1,257.60	1,426.19	+13.4
Indonesia Jakarta Comp	3,809.14	4,316.69	+13.3
Italy FTSE Index	14,908.53	16,471.95	+10.5
US Dow Jones Industrial Ave	12,217.56	13,104.14	+7.3
Brazil Ibovespa	56,534.00	60,952.00	+7.8
UK FTSE 100	5,572.30	5,897.80	+5.8
Canada TSX Comp	11,955.10	12,433.50	+4.0
China Shanghai Comp	2,199.42	2,269.13	+3.2
Portugal PSI20	5,494.27	5,655.15	+2.9
Spain IBEX 35	8,487.90	8,167.50	-3.8

Source: Bloomberg

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Selector – Our view of the bigger picture

We are told that times are tough and the outlook is difficult for many businesses. We agree, but that in itself is not why some businesses do well and others struggle. The need to adjust to the prevailing economic landscape and make changes accordingly is what good businesses must do in order to survive.

In our September 2012 quarterly newsletter we outlined why we didn't agree with the prevailing negative view surrounding equities. However our approach is not to question whether markets are right or wrong but to focus our efforts on uncovering the businesses and managers that are able to navigate their way through the maze.

There are however structural changes under way that can significantly shift the investment thesis for many industries and businesses. Below we discuss three trends that are forcing change among businesses and investors.

Energy

Exactly one year ago, our December 2011 quarterly newsletter featured an article on the US shale gas industry and the repercussions that were likely to flow across the energy industry and broader economic community. Today, those observations are gaining traction with the prime beneficiary being the US economy.

Last month, The Economist wrote the following;

"The shale-gas revolution in America has been as sudden and startling as a super tanker performing a handbrake turn. A country that once fretted about its dependence on Middle Eastern fossil fuels is now on the verge of self sufficiency in natural gas. And the news keeps getting better. In the week the International Energy Agency predicted the United States would become the world's largest oil producer by 2020, outstripping Saudi Arabia and Russia.

Why has this happened? Oil has been costly for more than a decade. This has spurred prospectors to look harder for unconventional fuels: oil and gas that lie deep under the sea, buried in shale beds or stuck in Canada's vast oil sands. They have developed technology to extract hydrocarbons, with such success North America now has a gas glut. Prices have plummeted, prompting shale-gas frackers to drill for pricier shale oil instead."

In fact, in its annual World Energy Outlook report, the International Energy Agency (IEA) viewed the situation; *"A renaissance of the US energy sector is reshaping the world's energy landscape with far reaching implications."*

The US has been importing oil since the 1940's, a situation that exposed the country to OPEC induced oil shocks during the 1970's. Today the US economy is still importing oil to the tune of ten million barrels a day, however increases in US domestic production has led the IEA to forecast this

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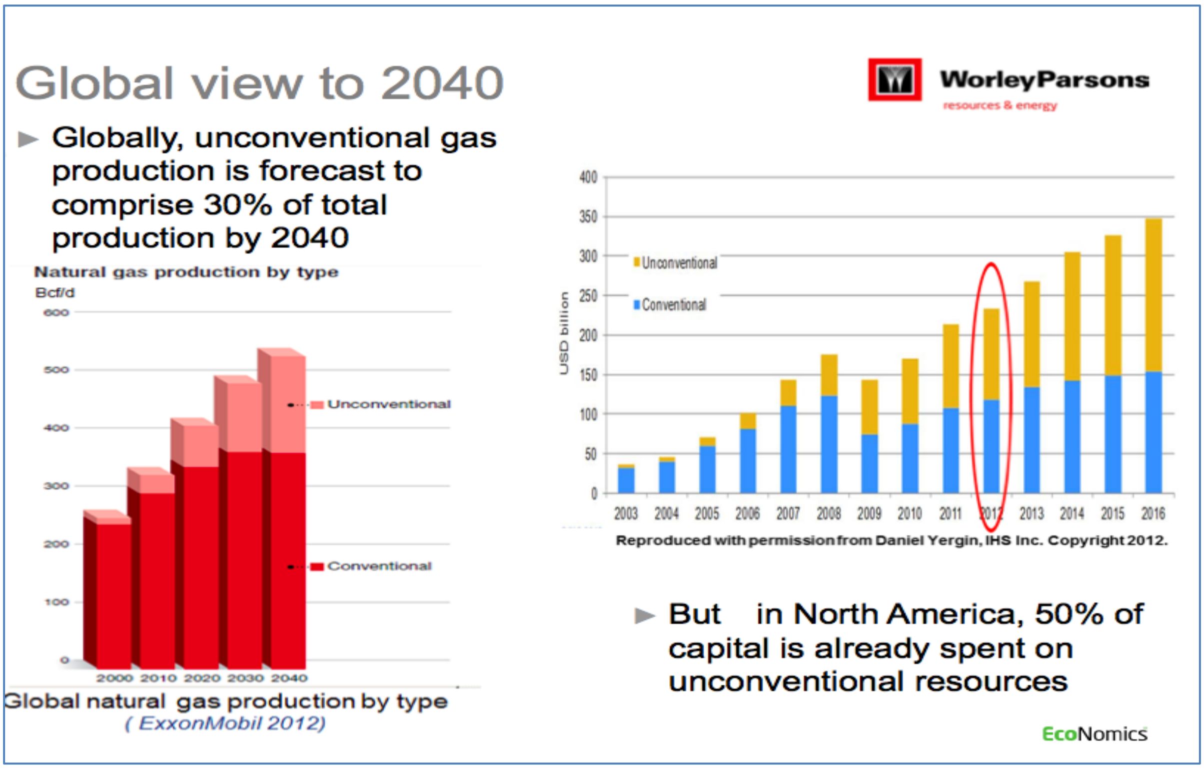
figure will drop to four million barrels per day by 2022 before becoming a net exporter by 2035. The obvious beneficiary of this situation is the US economy, which at the moment imports oil at over US$100 per barrel, with significant positive flow on impacts to its current account position. Similarly, the Middle East and specifically Saudi Arabia, stand to lose considerably as the energy power base shifts to countries able to tap into new resource provinces.

BHP petroleum chief Mike Yeager, estimates that the "shale gale" effect, that has seen a huge reversal in US energy self sufficiency, will result in lower gas tariffs and an estimated saving to the US economy of US$100 billion a year and a drop in the cost of living per person of about US$900 a year. As **Figures 1** and **2** highlight, the US move into shale gas development has been nothing short of extraordinary and if the forecasters are proven right, will see unconventional gas becoming a dominant source of new energy.

Figure 1: **Growth of Unconventional Gas Production**



Source: Worley Parsons presentation investor day

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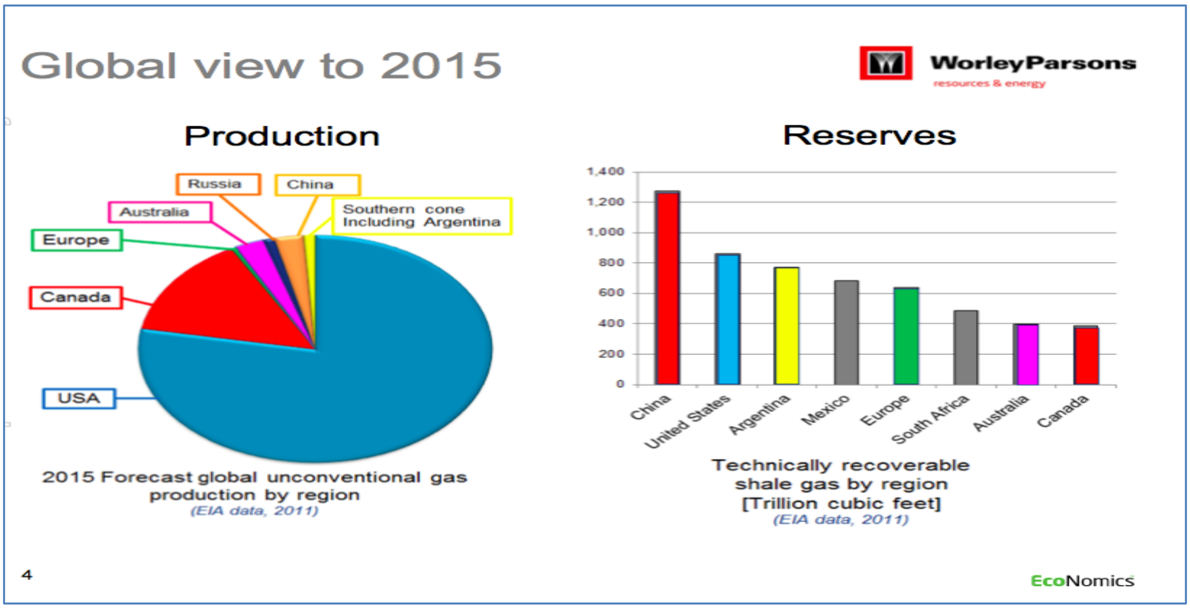
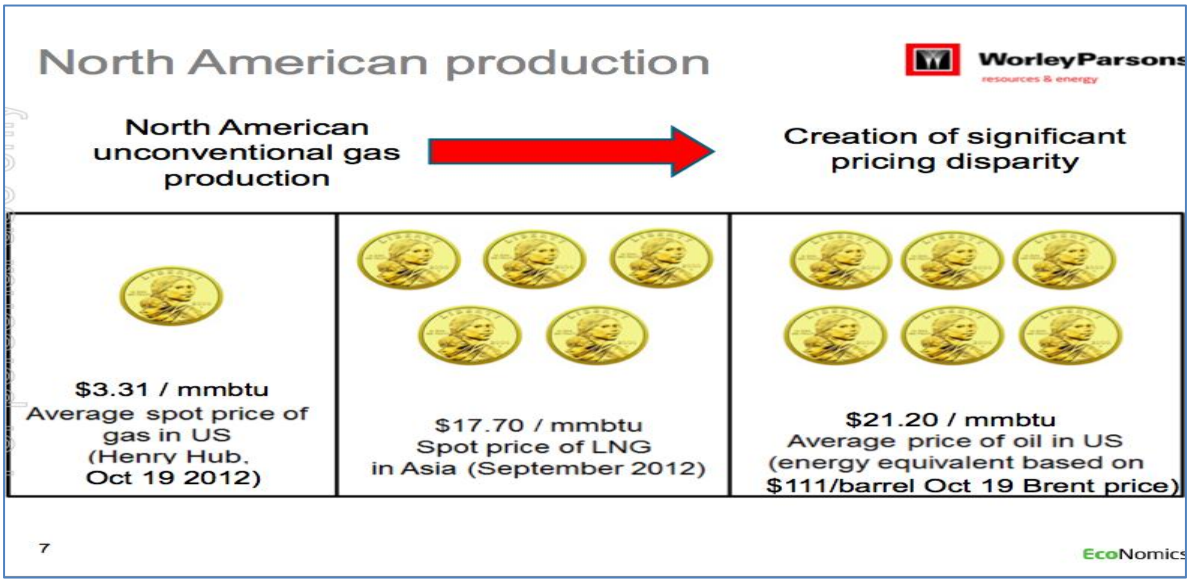
Figure 2: Global Unconventional Gas Producers & Reserves



As with any new found supply, the impact on pricing can be sudden. As **Figure 3** highlights, the collapse in gas prices in the US to around US$3.31 per unit is equivalent to selling a barrel of oil at $US21.20 and compares to the current Brent crude price of $US111. With US gas prices trading at large discounts to traditional LNG import prices, pressure is mounting on producers to adjust prices. Already reports are pointing to Asia's biggest buyers, which are totally reliant on overseas sources for their energy supplies, queuing up for US shale gas.

Figure 3: Unconventional Gas impact on pricing



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The jury is still out on the long term implications that shale will have on energy pricing, however the OPEC Chief Abdalla El-Badri noted that, “Peak oil supply will arrive one day – it is a non-renewable resource after all – but at present, this day is being pushed further and further into the future.”

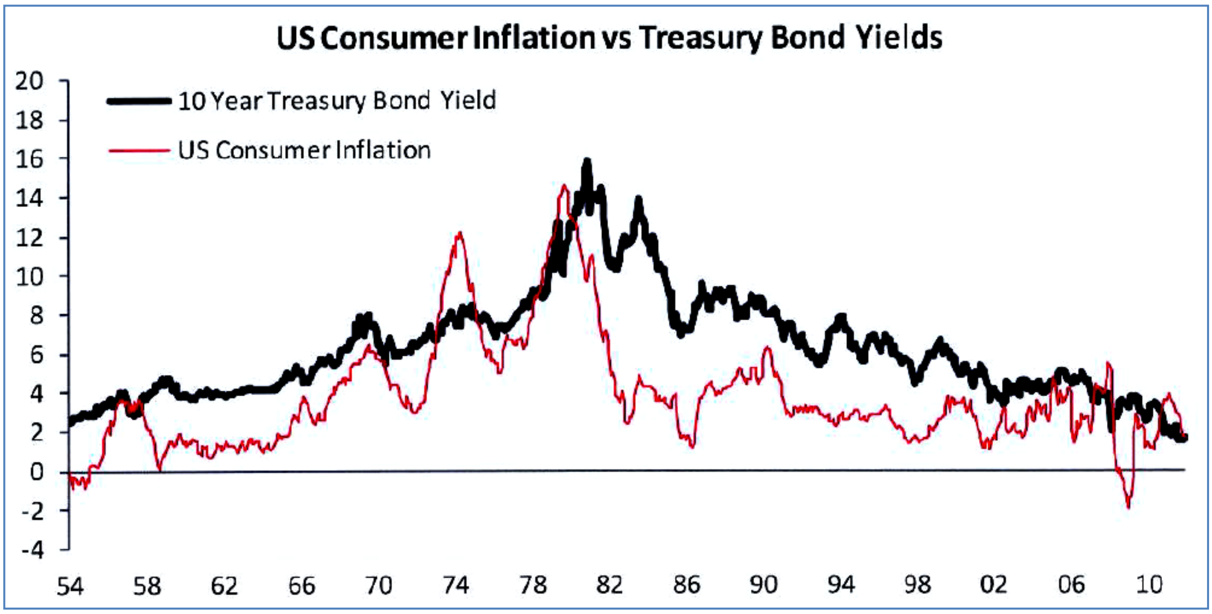
In the meantime the US finds itself in an enviable position, becoming less dependent on the outside world to meet their energy needs and providing its economy with a growing and competitive manufacturing base. Data distributed by BHP noted that US oil production will hit 11.4 million barrels per day by the end of 2013, with shale oil production contributing upwards of thirty percent of this figure. In contrast Saudi Arabia averages 11.6 million barrels per day, putting into context just how significant this development is.

The US economy has its issues, no one doubts that. But as the Australian Financial Review recently noted “A Renaissance of the US energy sector is starting.” This could just be the get out of jail card this country has been seeking. ***SFM***

Interest rates

A quick glance at **Figure 4** denotes one thing, interest rates have been on the slide for a long time. Having peaked during the 1980’s, US 10 Year Treasury Bonds have retreated to current levels of 1.60%. Go out 30 years and US Treasury Bonds are yielding 2.75%, a figure that many smart investors, including James Grant would caution against (refer to our March 2012 quarterly newsletter).

Figure 4: Where rates have been heading 1954 - 2012



Source Macquarie Equities

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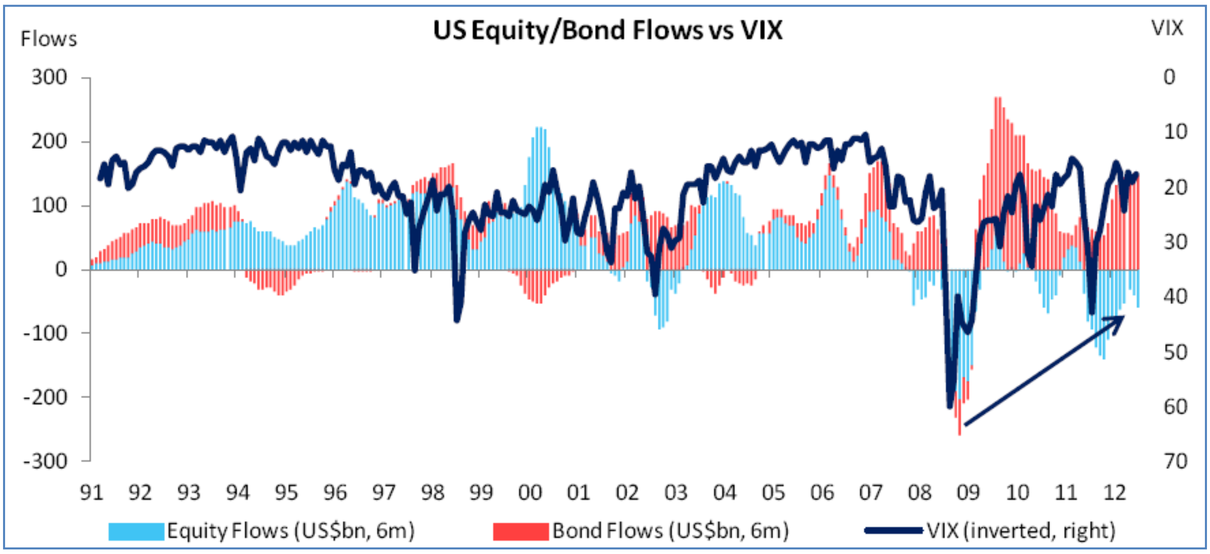
Such is the importance of what Grant said at the time in 2011 that it is worth repeating once again.

"It's implausible to yield nothing and in some cases less than nothing. You compare and contrast it with 30 years ago when treasuries yielded in the teens. Back then nobody wanted the stuff but it turned out to be the greatest investment of its generation. I think it's going to prove to be the worst investment of the next generation."

And yet **Figure 5** shows precisely where the money is flowing in the US. Yes, the blue bars indicate money flowing out of equities and the red bars show the flow of money into bonds. Despite the collapse in yields, investors are still moving into cash, no doubt in search of safety.

Figure 5: Where money has flowed 1991 – 2012



Source: Macquarie Equities

However the collapse in yields presents an even stronger case for equities over the medium term. A protracted period of lower funding costs provides businesses with the necessary breathing space to undertake change and re-investment. Growth is hard to come by, the economic numbers clearly show that, however the conditions are now more in favour of industries that are prepared to invest and with funding costs coming down and banks looking to lend, we see room for economic optimism led in large part by a revitalised US economy.

Banks

It has been four years since markets were buffeted by the global financial crisis and still the fall out can be felt. In truth, the repercussions will be with us for many more years as governments and businesses look to repair balance sheets and restore public confidence. Unfortunately with any fallout of this magnitude, there is a price to be paid and in the case of banking it comes in the form of re-regulation. Quietly, slowly, financial institutions have come under the regulators radar. The

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financial crisis has simply hastened the process that will ultimately lead to banks having to carry more capital. In Australia, the major banks are at pains to tell anyone prepared to listen that they are well capitalised, with Tier 1 capital ratios of 7.5 to 8.8%. What this means is that based on the major banks' common equity, they are leveraged between 16 and 20 times. That is, for every dollar of shareholder capital they have about 16 to 20 dollars of assets.

However, calculating or "risk weighting" a bank's portfolio of loans has given rise to differing opinions. For example a home loan carries a risk weighting of less than 25 per cent, thus ensuring that banks can lend four dollars for every one dollar of shareholder capital required. In contrast borrowers that are deemed riskier, carry a higher capital burden in the eyes of regulators, forcing banks to hold more shareholder equity as a result.

In 2008, the Australian Government guaranteed scheme was introduced to provide confidence to lenders, given the extraordinary developments in the global system at that time. In March 2010, the scheme was closed to new borrowings as conditions improved, however for all the banks, the events of 2008 provoked a rethink on funding. Prior to 2008, our major banks largely funded their credit growth demand via the overseas wholesale funding market. This was a market that was large, easily accessible and competitive on price, far more so than the traditional funding route of domestic bank depositors. The drawback, as the events of 2008 have so clearly demonstrated, centred on the short term duration of its funding, typically three to six months rolling, thereby providing no long term funding certainly on loans typically multi-years in duration.

Post 2008, banks have re-discovered a new found respect for depositors. In a dash to stabilise their funding sources, the major banks have engaged in an interest rate bidding war to attract new depositors. As a result, depositors now make up some 60%-70% of the major banks funding requirements, a vast improvement on the 50% type levels that existed pre 2008.

However, this too has its drawbacks, as the major banks are indeed finding out. Under the new banking laws that come into effect on January 2015, called Basel III, the Australian Prudential Regulatory Authority (APRA) will start discriminating between "good" and "bad" deposits. As noted by Christopher Joyce writing in the Australian Financial Review in November 2012, APRA will look to classify deposit money, sourced from depositors with long standing banking relationships as stable, while the more volatile promotional type deposit deals will be categorised as unstable. In essence, APRA is seeking ways to separate "passive" deposits from "active" deposits and in so doing determine the level of capital the banks should carry as a result. The more active the deposit base, the steeper the funding costs, as the need to provide more equity as a buffer, will necessitate lower returns on equity earned.

In work undertaken by Commonwealth Bank chief Credit Strategist, Steve Shoobert, among the four big banks, taking into account both the "active" level of deposits and their corresponding volatility, National Australia Bank has the highest variability of deposit instability (5.1%), closely followed by ANZ Banking Group (5.0%), CBA (3.3%) and finally Westpac (2.9%).

The banking industry is on notice. Government re-regulation of the banking system is unlikely to prevent the next financial failure occurring, however financial institutions deemed too big to fail has placed regulators in a difficult predicament. One option is where regulators are seen to be doing something constructive and enforceable. In the case of the Australian banks, Reserve Bank Governor Glenn Stevens said, the majors would indeed need to "hold a little bit more capital given their status as domestically systematically important financial institutions", arguing that it was not unreasonable to insist "on more capital to lessen the probability of the state having to step in again."

The CEO's of our major banks won't necessarily agree and perhaps nor will the shareholders, who will need to accept lower returns as a by-product of having to hold more equity. But regulators are in no mood to argue, as they pull out all stops to prevent a repeat of the 2008 financial crisis. That's the hope anyway. ***SFM***

Thorn Group - telling it how it is

In our business of analysing companies, separating fact from fiction and truth from half truths is part and parcel of what we do every day. Management of businesses have a duty to shareholders to operate and make investment decisions for the benefit of all owners, over both the short and long term. In that context it was interesting to read the comments of financial services company Thorn Group, a business that the Fund doesn't currently hold, following its recent interim results. Having recorded a two percent fall in net profits to $14 million, CEO John Hughes noted that challenging market conditions had significantly affected its rate of growth in the first half and "this trend will follow into the full year result." The shares dived ten percent on the back of the result and comments.

Hughes also noted that the underlying business – being Radio Rentals – was strong and benefiting from the number of initiatives implemented over the past year and that despite the market's reaction he would not be apologising for the significant investment it was making adding;

"Investments take time to garner results. I think there's been too much in the market today of short-termism where companies are just so worried about the market and investor reaction that they go for short-termism rather than being brave enough to say we are investing for the future."

We agree with Hughes and share his frustration but investors need to make the distinction between those companies that work for shareholders and those that do their level best to confuse and destroy value. ***SFM***

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Table 2: NIB Holdings 1952-2012

Year	Event
1952	Newcastle Industrial Benefits (NIB) established by workers at BHP Steelworks.
1962	NIB moves into its first head office Hunter Street, Newcastle.
1976	Medibank Private opened for business and competitor to NIB.
1977	Newcastle Industrial Benefits becomes NIB Health Funds.
1982	NIB opens first Sydney branch in CBD.
1984	Government establishes Medicare health insurance.
1988	Newcastle Knights enters NSWRL with NIB as founding sponsor, continues to this day along with other codes.
1993	NIB expands interstate in Queensland, Victoria, South Australia and the ACT.
2000	Introduction of Federal Government's Lifetime Health Cover boosts memberships.
2007	Nov - Health fund insurer NIB Holdings lists on Australian stock exchange following member vote to demutualise, 518 million shares @ $0.85 per share, equal to a market capitalisation of $440 million. Market share 6.0%
2008	Feb - NIB launches partnership agreement with Tower Australia to offer life insurance products, branded NIB.
2008	May - Federal Government announces proposed changes to Medicare Levy Surcharge, impacting industry.
2008	Aug - Net profit $26.7 million, net underwriting margin of 4.4%, dividend of 2.1 cents per share and 10% share buy-back and excess capital of $105 million reported, following group's first reported result to the market.
2008	Sep - Governments Medicare Levy Surcharge bill rejected by the Senate, NIB upgrades profit guidance.
2008	Oct - Company rejects offer for business valuing the NIB business at $1.15 - $1.20 per share.
2009	Mar – NIB receives government approval for premium increase of 5.18%.
2009	Jun- NIB proposes to buy-back unmarketable parcels of shares, totalling 22 million @ $1.04 per share.
2009	Aug - Net profit $23.8 million, full year dividend of 7.4 cents, total policyholders 384,288, market share 7.1%.
2010	Feb - Government confirms premium rise of 5.95% for NIB, company maintains margin guidance of 5.0% - 5.5%.
2010	Aug – Net profit $61.5 million, full year dividend 7.0 cents, premium revenue up 8.7% to $901 million.
2010	Sep – NIB announces acquisition (International Medical Assistance Network) IMAN International @ $25 million.
2010	Oct - NIB launches $140 million cash bid for competing Geelong based health insurer GMHBA.
2010	Oct - NIB confirms cancellation of 27 million NIB shares (5.5% issued capital) relating to unverified policyholders.
2010	Nov - NIB's revised $180 million offer for GMHBA rejected with offer lapsing.
2011	Feb - Government confirms premium rise of 6.19% for NIB, company maintains margin guidance of 5.4% - 5.7%.
2011	Jul – NIB returns capital of $75 million to shareholders, approximately 16 cents per share from cash reserves.
2011	Aug – Premiums exceed $1 billion for first time, net profit of $65.5 million, full year dividend 13 cents, includes 5.0 cent special. IMAN premiums for part year contribution $16 million, net underwriting profit $2.8 million.
2012	Feb - Government confirms premium rise of 5.5% for NIB.
2012	Jul – NIB alliance with UnitedHealthcare International providing health coverage for mobile customers.
2012	Aug - Premium income hits $1.1 billion, net profit $67.6 million, full year dividend 9.25 cents.
2012	Oct – Government announces changes to private health insurance rebate effective FY14. From April 2014, rebate on health insurance premiums to move in line with CPI, thereby capping escalating health costs.
2012	Nov – NIB acquires Tower Medical Insurance for A$80 million, with 169, 000 policyholders, annual premium revenue of NZ$140 million and market share of about 13%. NIB funds acquisition using existing surplus capital and a modest amount of debt.
2012	Year- end total policyholders 471,455, market share 7.6%, issued capital 439 million shares, market capitalisation $878 million.

Health Insurance

The Fund recently added NIB Holdings to its portfolio holdings. Roughly half of the population are covered by one of over thirty private health fund offerings. The industry is dominated by a handful of players with the top six - led by government owned Medibank Private - controlling over 80% of the $10bn plus annual premium market. Number six on the ladder with a 7.6% share, is Newcastle based NIB Holdings.

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Formed in 1952 as the Newcastle Industrial Benefits Hospital Fund, its status as a not-for-profit fund ceased following policy holders overwhelming vote in July 2007 to follow the well worn path to demutualise, thus becoming Australia's first publicly listed health insurer.

Prior to 1984, private health cover was a given, with 62% of the population carrying some level of insurance protection. The introduction of Medicare's universally free medical cover virtually put a stop to private health demand. The industry's circuit breaker in 1999 came in the form of the Government's 30% health premium rebate followed by its Lifetime Health Cover a year later - an initiative that penalises individuals who delay taking out cover.

NIB's stellar growth profile

As **Table 3** highlights, with the industry winds behind its back, NIB has enjoyed stellar growth over recent years, driven by a smart advertising campaign that focuses on the under 40's age demographics. In short, NIB's targeted marketing and cost conscious policy approach has delivered the group a growing band of new health members.

Last year NIB collected $1,123m worth of premiums from its 471,500 member base and recorded an underwriting profit of $70.7m. Another $26.5m came from the group's investment portfolio, resulting in a pre tax profit of $95.6M. On most key financial metrics, NIB management led by CEO Mark Fitzgibbon and CFO Michelle McPherson have delivered impressive levels of growth whilst rewarding shareholders with capital returns and rising levels of dividends. This has been made possible by a long term adherence to targeting an adequate return on equity. As **Table 3** shows, while the group has successfully lifted premium revenues, more importantly net margin – reflecting what the group gets to keep after paying all claims - has lifted from 2.9% in 2005 to 6.3% during 2012.

Table 3: NIB financial summary 2005 - 2012

	FY05*	FY06*	FY07*	FY08	FY09	FY10	FY11	FY12
Premium Revenue $'M	530.7	611.9	666.0	758.2	829.5	901.4	1,007.8	1,123.8
Claims Costs $'M	459.1	500.1	569.8	551.3	599.9	636.0	693.1	765.4
Underwriting Profit $'M	15.4	51.4	23.7	33.0	40.2	47.1	61.5	70.7
Investment Income $'M	17.4	18.6	32.4	30.0	-1.8	44.5	33.4	26.5
Pre Tax Profit $'M	26.8	69.9	52.9	45.8	31.6	87.0	91.9	95.6
Tax $'M	n/a	n/a	n/a	13.7	7.8	25.5	26.4	28.0
Net Profit $'M	n/a	n/a	n/a	32.1	23.8	61.5	65.5	67.6
Net Margin %	2.9	8.4	3.7	2.5	4.8	5.2	6.1	6.3
Management Expense Ratio %	10.6	9.9	10.7	10.3	9.9	9.6	9.7	9.2
Combined Expense Ratio %	97.1	91.6	96.3	97.5	95.2	94.8	93.9	93.7
Number of Persons Covered '000	290.9	302.3	328.8	365.4	384.3	107.0	446.5	471.5
Lapse rates %	n/a	n/a	7.7	9.4	8.6	8.9	9.0	9.4
Return on Equity %	n/a	n/a	n/a	7.0	6.6	16.3	16.5	21.7

** Not for profit pre float*

Unlike other forms of insurance, health insurance is a reasonably straight forward exercise for both parties. For the insurer, premiums are collected with the bulk of payments occurring in the same year. As such, health insurance is termed short tail in comparison to other forms of insurance including life insurance where the premiums are collected in one period and payments made some many years later.

The key is to limit the rise in claims expenses to within acceptable levels so that an underwriting profit can be achieved. To this end NIB has successfully controlled costs, having delivered underwriting profits over many years.

CEO Fitzgibbon has cautioned though that increasing competition and rising health costs will limit margin growth in future periods. As he noted, back in 2006 the competition were asleep at the wheel. Today, the likes of Medicare Private and BUPA have both stepped up to the plate with aggressive campaigns to win over the hearts and minds of new and existing customers.

Government role

While Fitzgibbon remains confident that the group can continue to outpace the industry's rate of growth, the key risk to margins lies in what governments do, as they ultimately control the purse strings and have the biggest influence on consumer behaviour. Having introduced lifetime health coverage in 1999, via the 30% premium rebate, the Government has recently moved to rein in the costs. From 2014, the Government will freeze annual health premium rises in real terms, capping any move in line with inflation, thereby throwing any additional expenses back onto the health providers and ultimately the paying consumers.

Despite this, Fitzgibbon remains decidedly upbeat and notes that "with 34 insurers in the market, I expect the forces of competition will do a better job than Government in keeping premiums as low as possible. I've often argued that Government price control is a form of price fixing and not in the interest of consumers."

Acquisitions

Those of you who have followed us through our newsletters will note that we are not big fans of businesses that grow by acquisition. This type of business strategy carries with it enormous execution risks without a real appreciation of the actual risks undertaken.

When NIB first listed, we were aware that one of Fitzgibbon's chief motives in doing so was to grow via acquisitions. We were naturally apprehensive regarding this strategy and despite Fitzgibbon's best efforts to date, NIB has fallen well short of convincing other competing health providers to join forces. Fast forward the five years since listing and the NIB business now comprises three revenue streams. As **Table 4** highlights, the move into related health insurance products is only recent but the early signs are promising.

Health Insurance Business (HIB)

The HIB remains the group's traditional health insurance offering, delivering the bulk of premium income and earnings. NIB is well positioned with a clear branded offering and competitive pricing. While the lapse rate has increased in recent years from 8.9% per annum to 9.4%, a tight control of costs has the group well positioned to take on many of the industry players. Importantly the group has been proactive in the use of new technology to promote new sales. Today, only 13% of sales are directed from the group's retail branch network, while 31% flows from online and another 22% from industry brokers including specialist group iselect.com.au, who offer an independent online health insurance comparison model.

Table 4: NIB business units

	FY08	FY09	FY10	FY11	FY12
Premium Revenue $'M	**758.2**	**829.5**	**901.4**	**1,007.8**	**1,123.8**
- Premium revenue (HIB)	758.2	829.5	901.4	991.3	1095.6
- Premium revenue (ISB)	-	-	-	0.5	3.0
- Premium revenue (IWB)	-	-	-	16.0	25.2
Gross underwriting result $'M	**111.2**	**122.0**	**133.5**	**159.1**	**174.6**
- Gross underwriting result (HIB)	111.2	122.0	133.5	159.1	159.9
- Gross underwriting result (ISB)	-	-	-	0.3	0.1
- Gross underwriting result (IWB)	-	-	-	8.4	14.5
Net underwriting profit $'M	**33.0**	**40.2**	**47.1**	**61.5**	**70.7**
- Net underwriting profit (HIB)	33.0	40.2	47.1	59.8	64.6
- Net underwriting profit ISB)	-	-	-	-1.1	-1.4
- Net underwriting profit (IWB)	-	-	-	2.8	7.5

International Students Business (ISB)

ISB entered the market in 2010, providing international students health cover. With over 500,000 overseas students studying in Australia every year, about $120 million worth of health premiums are written annually. Being a start up business, the jury is still out as to whether NIB can grow this business into a sustainable, profitable operation. In 2012, premiums rose to $3 million, while net underwriting losses increased to $1.4 million, on health cover provided to around 3,300 students.

International Workers Business (IWB)

IWB was acquired for $25m in 2010 and is a specialist provider of health cover for temporary migrant workers in Australia. Similar to ISB, Australia enjoys a growing influx of skilled workers who require health cover. NIB is enjoying excellent take up, reflected in annual premiums rising to $25.2 million in 2012 along with a net underwriting profit of $7.5 million and coverage for 16,480 policyholders, up from 13,899 in 2011.

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Tower Medical Insurance New Zealand acquisition

During November 2012 NIB announced its largest deal to date, the acquisition of New Zealand based Tower Medical insurer for A$80 million. NIB's association with parent Tower Limited spans back some four years when a partnership was established allowing NIB to offer life insurance products. Fitzgibbon's acquisition of Tower's health insurance business has been a long time coming, however both camps claim a great result in the outcome. Obviously whenever you get a buyer and a seller, the real winner is not known for some time.

NIB claim that the price paid and Tower's 13% market share provides the group with; *"an opportunity to emulate the success NIB has achieved in Australia since its listing in 2007 through brand building, product design, distribution and outstanding customer service. New Zealand is a market with similarities to the Australian health insurance landscape early last decade. There's one dominant player, no obvious competitive tension and the Government knows budget constraints mean there must be more future private funding of healthcare."*

We don't believe it will be that easy but the price paid appears attractive and management are confident that the acquisition will "result in substantial, immediate accretion to earnings per share and return on equity."

NIB Management

NIB has delivered for shareholders since listing and a large part of that can be directed towards the management team of CEO Fitzgibbon and CFO McPherson. With surplus funds, NIB has been proactive in returning funds to shareholders including, a $75.4 million capital return in July 2011, $23.3 million in special dividends and a completed $41 million on-market share buy-back.

While the Tower acquisition will see the group take on a small amount of debt for the first time, management has committed to return funds via a higher dividend payout ratio of 60-70%, up from 50%-60%.

Share ownership among management has also been on the rise, with both Fitzgibbon and McPherson holding NIB stock valued at $2.5 million and $670,000 respectively at the June balance date.

Summary

Management have steered a steady ship since listing, delivering on most financial metrics. While increased competitive pressures and government changes to health insurance will make life tougher for all players, NIB appears up to the task. The sale of Tower Medical by Tower perhaps highlights the next trend to emerge, of groups looking to exit businesses that are not core. To this point NIB have shown restraint in pursuing these opportunities and we suspect that this is unlikely to change whilst current management are at the helm. An attractive 5.0% fully franked yield and a defendable business model underpins our confidence in the NIB business. ***SFM***

Company visit diary December Quarter 2012

October

CCP	Credit Corp site visit	08/10/12
SRX	Sirtex Medical macquarie health conference	10/10/12
POH	Phosphagenics macquarie health conference	10/10/12
ACR	Acrux macquarie health conference	10/10/12
UBI	Universal Biosensors macquarie health conference	10/10/12
NAN	Nanosonics macquarie health conference	10/10/12
PXS	Pharmaxis macquarie health conference	10/10/12
PXS	Pharmaxis Q1 2013 conference call	11/10/12
ABC	Adelaide Brighton management meeting	11/10/12
COH	Cochlear annual general meeting	16/10/12
CSL	CSL annual general meeting	17/10/12
PXS	Pharmaxis annual general meeting	17/10/12
JIN	Jumbo Interactive management meeting	18/10/12
CSL	CSL new ceo management meeting	19/10/12
SRX	Sirtex annual general meeting	23/10/12
WOR	WorleyParsons investor day	24/10/12
FXL	Flexigroup investor day	25/10/12
RMD	ResMed Q1 conference call	26/10/12

November

PPT	Perpetual annual general meeting	01/11/12
WHC	Whitehaven Coal annual general meeting	01/11/12
NHF	NIB Holdings acquisition conference call	02/11/12
NWS	News Corporation Q1 conference call	07/11/12
CCP	Credit Corp annual general meeting	08/11/12
JHX	James Hardie Q2 conference call	15/11/12
FXL	Flexigroup annual general meeting	26/11/12
TNE	Technology One FY12 results briefing	26/11/12
ALQ	ALS HY13 results briefing	28/11/12
ALL	Aristocrat Leisure FY12 results briefing	28/11/12
JIN	Jumbo Interactive conference call	30/11/12

December

SRX	Sirtex Medical site visit	03/12/12
COH	Cochlear site visit	03/12/12
RMD	ResMed site visit	03/12/12
PXS	Pharmaxis BBY health care conference	05/12/12
n/a	Hatchtech BBY health care conference	05/12/12
BCT	Bluechiip Tracking Solutions BBY health care conference	05/12/12
PAB	Patrys BBY health care conference	05/12/12
CSL	CSL R&D investor day	06/12/12

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FWD	Fleetwood Corporation management meeting	11/12/12
NTC	Netcomm Wireless management meeting	12/12/12
OTH	Onthehouse management meeting	19/12/12
TNE	Technology One management briefing	19/12/12
SKC	SkyCity Entertainment Group conference call	19/12/12

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