Selector Aust Equities Ex 50 Fund Quarterly Newsletter No.33

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In this quarterly edition we review performance and attribution. We do a roundup of the recent reporting season. Our macro focus is on the new global war. At home we take a look at the Federal Government and our miners and finally we discuss some global developments in executive pay. Photo: Currency Wars.

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selector

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,

Markets turned the corner during January 2013 in a classic reminder that buying in gloom provides the best form of capital protection. It doesn't entirely remove the risk of capital loss but it certainly provides a greater margin of safety. Having said that, the conviction to step in and invest in a business requires a couple of things. Firstly, a good understanding of what the business does and secondly, a mental preparedness to act despite the overwhelming majority urging caution.

During the past quarter, share markets have driven higher, led in large part by the US, with the Dow Jones Industrial Average Index up 11.2% to a new high of 14,573. Locally, our All Ordinaries Accumulation Index peaked in early March at 40,968, a rise of 11.8%. All in all, optimism has returned and with that comes some challenges. As valuations rise, the margin of safety sought with any investment diminishes and herein, investors are cautioned to proceed with care.

In addition, the events surrounding the bailout of the Cypriot Government during the latter days of March are a timely reminder that financial shocks remain a real and ongoing threat to investor confidence. While Cyprus has reluctantly agreed to terms with the 17-nation euro zone and the International Monetary Fund (IMF) for a 10 billion euro bailout facility, it has come at a significant cost to bank depositors. In a timely reminder that depositors run the real risk of capital losses, the terms of the agreement has led to senior Cypriot bank bond holders taking losses and un-insured depositors facing virtual wipe-out. It is not an ideal situation and the consequences run far deeper and wider than just the country of Cyprus. However, the option of bailing out governments and financial institutions whenever the situation dictates is becoming unpalatable and reflects a hardening stance in dealing with these issues following the 2008 financial crisis.

Whilst mindful of the economic backdrop, good investment opportunities continue to surface and the latest reporting period provided greater transparency to some of these. In this quarterly we explore a number of businesses and share our thoughts on their immediate outlook. We also reflect on our two big miners, discuss the new war facing governments and businesses and finally how one country is looking to tackle the thorny issue of executive pay.

During the past quarter and for the financial year to date the Fund has delivered gross positive returns of **8.51%** and **37.17%** respectively, as compared to the All Ordinaries Accumulation Index which returned **8.04%** and **24.84%** over the same periods. These results are pleasing and provide us with confidence that our investment approach is delivering meaningful results.

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

Regards
Tony Scenna
Corey Vincent

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The rise of super

Investment experts predict that by 2030 the local superannuation funds industry will have grown from the current $1.5 trillion to a figure closer to $5.0 trillion. At that point the industry is expected to be one and a half times larger than the gross domestic product (GDP) of our local economy. While industry funds will form a large percentage of this figure, the industry has also witnessed a surge in self managed super funds (SMSF). These SMSF's currently represent about $450 million of the total $1.5 trillion. In addition, applications for your new SMSF's have been pouring in at the rate of 1,000 per week, with total SMSF's likely to hit 500,000 in the very near term.

It is little wonder that the Government has primed the industry for a tax grab. Arguments will be made that the current tax concessions offered to those earning high sums of income should be modified, with the extra raised earmarked for the Government's consolidated revenue bucket.

And at stake is a higher contributions tax, suggested to be 30% rather than the current 15%, on incomes above $300,000. Don't be surprised that this threshold is lowered, judging by the Government's growing budget deficit when it reports in May. Unfortunately Governments are experts in tinkering with something working well in order to plug holes in things working not so well. *SFM*

Performance March 2013

For the quarter ending March 2013, the Fund delivered a gross positive return of 8.51% as compared with the 8.04% rise in the All Ordinaries Accumulation Index. Performance statistics are detailed on page 18.

Performance table since inception

% Returns	Gross Fund Return %	All Ords Index %	All Ords Acc Index %
3 months	+8.51	+6.76	+8.04
1 Year	+33.26	+12.67	+17.80
3 years	+7.68	+0.59	+5.01
5 years	+6.27	-1.64	+2.76
Since inception compound p.a.	+9.56	+2.86	+7.25

Top 10 March 2013*	Top 10 December 2012*
ARB Corporation	ARB Corporation
Carsales	Blackmores
Flexigroup	Flexigroup
Flight Centre	Flight Centre
IOOF Holdings	IOOF Holdings
ResMed Inc.	IRESS
SEEK	ResMed Inc.
SIRTeX Medical	SEEK
Super Retail Group	SIRTeX Medical
Technology One	Super Retail Group
Top 10 = 55.71%	Top 10 = 54.85%

*Listed in alphabetical order

Selector runs a high conviction index unaware stock selection investment strategy with typically 25-40 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	%
SEEK	+2.17	Pharmaxis	-1.61
Flight Centre	+1.41	Sirtex Medical	-0.94
Super Retail	+1.31	Blackmores	-0.77
Carsales	+1.11	Breville Group	-0.38
IOOF	+1.08	AMA Group	-0.21

As we will discuss further in this report, the latest reporting period always provided some surprises for investors. A tough economic backdrop and a number of external factors, including the strong Australian dollar impacted and in some cases unduly masked the results delivered. As the table above highlights, the main detractors for the quarter were largely restricted to three businesses, of which Pharmaxis has been the most disappointing. It is an investment that we have held for many years as the company sought to bring its cystic fibrosis drug Bronchitol to market. As is often the way, the path has been longer, proven more costly and delayed by a number of regulatory issues. To date, the company has succeeded in gaining approval and reimbursement in both Europe and Australia, however, the very important US market has yet to be achieved, with regulators now seeking further data. This has impacted investor expectations and required the company to reconsider its US strategy and funding arrangements.

In the case of Sirtex, the share price respite is more a function of the strong price move the company has enjoyed over the past few months. The company's interim result was solid and management continues to execute on a long term business plan to elevate its sir-spheres liver cancer treatment from the current salvage patient use to a first line treatment therapy. Blackmores suffered from a tough retail environment, which has seen the business provide greater store rebates to maintain sales and market share. Offsetting this has been the group's strong Asian expansion, with sales up 10% to $28.5 million during the half, although muted by a stronger currency.

On the plus side, a number of long held investments continued to shine during the quarter most notably SEEK, Flight Centre, and ResMed. Pleasingly, these businesses have sought to remain focused and have all successfully expanded offshore to provide greater depth and earnings diversity. SEEK in particular continues to make sizable investments in new markets and while current share price valuations appear full, we suspect these markets will provide ample room for growth in future years. We cover the Super Retail Group in more detail further in this report.

Finally, IOOF remains domestically based within the financial services space. During the half, management confirmed the good progress achieved following a number of recent bolt-on acquisitions. With a rebounding share market, IOOF is well placed to deliver solid growth in an industry that is undergoing structural regulatory change via legislated superannuation requirements. IOOF enjoys the benefits that comes with scale, ranking within the top six financial institutions locally, behind the big four banks and AMP. ***SFM***

Reporting season round up

For the most part, reporting season provides business leaders with the opportunity to update shareholders on how things are travelling. We say for the most part as there is a tendency for management to spin things their way. No investor wants to really hear that things are tough or that profits are down. But above all what investors dislike most are surprises, or more specifically negative surprises. However, in business, good and bad go hand in hand. Dealing with business adversity and preparing for growth are illustrative of good management teams doing what needs to be done.

In our September 2012 quarterly newsletter, of which past copies are accessible on our website under the heading newsletters, we outlined the investment philosophy that underpins the way we do things at Selector. Under the heading “Looking up rather than down”, we discussed how we approach every investment decision and every business review on the individual merits of the opportunity presented at the time. With this in mind, the next section brings into focus some of those that caught our eye during the latest profit round up. Some were good, while others disappointed. As always investors are quick to judge and share prices react sharply to the news of the day.

Those businesses and management teams delivering the not so good news, aim to soothe investors and reaffirm a business plan that they believe will deliver the returns expected. It is not easy and for our part we try not to judge too harshly companies that have a proven track record offset by occasional stumbles. As we discussed in our previous newsletters, this approach is underpinned by the four business qualities we seek in any investment opportunity considered;

1. Strongly aligned management team
2. Business with best of breed qualities
3. Balance sheet, conservatively positioned
4. Shareholder returns treated with paramount importance

Our search for these “best of breed” businesses is not restricted to the large. Many smaller businesses have both the drive and products to succeed and many do. However, what is becoming increasingly clear to us is the importance that incumbency and scale bestows on an organisation. Not only does it allow them to fight a good fight with a market leading position but it also allows them to invest for the future.

It is often lost on investors that investing for tomorrow is more critical than the profits of today, because when you buy into a business, you are paying for its future earnings stream. So with this in mind we listened to, reviewed and in some cases visited the following companies and their management teams during the past quarter. Some of these the Fund already owns, while others are under consideration.

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1. SAI Global (SAI): share price $3.37 | market capitalisation $693 million

Business background

SAI Global's website outlines its business as "providing organisations around the world with information services and solutions for managing risk, achieving compliance and driving business improvement." Even those unfamiliar with SAI would recognise the group's "5" tick logo that endorses independent assessment of products and services. This is the core business that was floated onto the stock market in 2003. There was much to like back then as the business had all the hallmarks of a great investment - simple, monopoly and an annuity income stream model.

A good business can be put at risk from poor execution. And the early signs weren't good with previous management embarking on a series of acquisitions, increasing both the debt levels and shares on issue. The new management team, led by CEO Tony Scotton continued along this path, with the very best of intentions to build three stand alone formidable businesses, encompassing Standards regulation, product certification and compliance risk management.

We are mindful of the pitfalls that can befall a business seeking to grow by acquisitions and as a result we have preferred to watch from the sidelines. Our patience has been rewarded thus far with the group's latest results failing to meet investor expectations. In short, while the original Standards business provides a dependable earnings base, the newer earnings streams of compliance and property servicing have added costs and execution risk. Management is confident that these issues can be sorted out and that the expected strong growth that underpinned these investments will be evident in future periods.

Our view

Our issue has always been, can management avoid the perils of growing too fast whilst taking on debt? As things currently stand, SAI has over $550 million worth of intangibles on its balance sheet and net debt of about $200 million. Group revenue is expected to hit $480 million for 2013, while net profits are forecast to reach $41 million. On this basis SAI is travelling on a prospective PER multiple of 13 and a fully franked yield of 4.4%.

To date the group has struggled with bedding down acquisitions undertaken in its compliance division and the road ahead will require considerable time and will test management's resolve. SAI unquestionably operates three high quality businesses, however it remains to be seen whether current shareholders will continue to give management the benefit of the doubt. SAI is certainly a stock worth watching and should it stumble further the asset quality is such that a takeover of the business couldn't be ruled out.

2. Jumbo Interactive (JIN): share price $2.50 | market capitalisation $100 million

Business background: The name Jumbo Interactive gives little away to the group's business activities, other than to suggest something big. In short, the company has developed a successful online lottery business that has been in operation for over a decade. The group's founding CEO and largest shareholder Mike Veverka is successfully exploiting the growing adoption of online lottery playing in much the same way that online has emerged in most walks of life. The total global lottery business is valued at $250 billion, while online is currently in its infancy and represents about $2.5 billion of this total. Importantly, lottery playing is played socially and accepted for what it is, a small wager to earn a considerable payout, despite the long odds.

For governments it represents a valuable source of revenue and in keeping with the changing trends in technology, the emergence of online playing has opened the door for Jumbo and other lottery providers to exploit this significant global opportunity. From its origins stretching some 13 years in Australia, Jumbo has built a $100 million local online lottery business. The group enjoys a long term relationship with lottery provider Tatts Group under existing reseller agreements, although there is a risk that future agreements may not be renewed. Management is candid that such an event cannot be ruled out, although the group is prepared should this ever eventuate.

In the mean time, the business has grown rapidly over the past five years and with no debt and a current cash balance of $16 million, CEO Veverka has moved to secure new opportunities in the global markets of the US, Mexico and Germany. These are early days but the online emergence of lottery playing is growing in size and Jumbo seems to have a well thought out strategy. The capital requirements are relatively small and the business is in strong shape to undertake the task.

Our view

We acknowledge that the risks in Jumbo are higher but also note that management have stuck to their core competency, remained debt free and executed on a strategy that appears realistic. We invested in Jumbo some time back and despite the strong move in the company's market value we remain on board.

3. IRESS (IRE): share price $7.75|market capitalisation $992 million

Business background: We profiled the IRESS business in our March 2010 quarterly newsletter. Those who operate in financial markets or financial planning businesses would be familiar with the group's core offering as a leading software supplier of services and trading platforms to the financial markets. The business has evolved since its founding in 1993 and importantly now enjoys both scale and market incumbency. Management is not ashamed of doing what's right for the long term health of the business despite the short term financial impacts that such decisions carry, as evidenced by the lower full year reported profit for 2012.

A case in point is the group's preparedness to target new overseas markets by investing small sums of money to execute the plan. This is a strategy that has served the company well and delivered excellent financial outcomes without taking undue risk. Today, the IRESS trading platform dominates

the local market, allowing stock brokers, fund managers, financial planners and individual clients to gain access to live data feeds while also providing all the necessary compliance requirements. The key to the IRESS business is that it is a subscription based model delivering time critical information. As such IRESS is a must have service that will live or die based on what the client requires and the company delivers.

On this point, the company has worked hard to develop long lasting relationships and this has been reflected in the most recent announcements from its newest market the United Kingdom. Here IRESS has beaten the incumbents to supply Sesame Bankhall and Towry, two of the largest wealth management groups in the country, with IRESS's XPLAN financial planning business software. This is a market opportunity multiple times larger than Australia and provides considerable confidence that the money thus far invested will deliver excellent returns over the ensuing years.

Our view

We applaud the business ethos that underpins IRESS and its management team. They think and act long term and their financial record stands as public record of what can be achieved when vision, focus and a conservative approach is applied sensibly. The business survived the financial crisis of 2008 in very good shape, despite the drop in client demand. More importantly, while management have continued to invest for tomorrow, a debt free balance sheet and a high annuity type earnings stream has allowed the group to reward existing shareholders with an attractive dividend stream that currently represents a 5.0% yield.

4. Computershare (CPU): share price $10.10|market capitalisation $5,617 million

In many areas Computershare has similarities to IRESS. A business which had its origins in Australia has now become the largest global share registry player with revenues approaching $2 billion and net profits exceeding $300 million. The founder and now chairman Chris Morris is no longer running the business but his initial approach to build and operate a proprietary software platform has allowed the group to act as an aggregator of registry businesses both here and abroad. Today, the group services over 30,000 global clients, predominately around financial markets and specifically registry management.

At its heart, the Computershare business involves a scalable information gathering service that charges on a per customer basis. As such, the company benefits enormously from economic growth and when financial markets are positive, as this invariably leads to more corporate activity and increasing numbers of shareholders that require the service. It would come as no surprise that the last few years have been tough on companies like IRESS and Computershare, who rely heavily on the positive health of the equity markets. However unlike other cyclical businesses, Computershare enjoys scale, incumbency and an annuity type income stream. This has seen the company weather the global financial crisis whilst also taking advantage of acquisition opportunities.

Our view

We have held a positive view on global share markets and in particular the US for some time now and a business like Computershare is not only a best of breed business, it also enjoys wonderful

earnings leverage when conditions allow. Management has delivered excellent returns on the capital employed thus far and our view remains that Computershare is a share to own for most seasons.

5. Skilled Engineering (SKE): share price $3.50|market capitalisation $847 million

Business background: The Skilled group is Australia's and New Zealand's leading provider of staffing services. A national operator with over 170 offices, Skilled assists clients with their workforce requirements and skilled labour needs. As such Skilled employs over 50,000 trade and technical specialists covering a wide range of industries including mining, oil and gas, transport, defence and infrastructure. The business was founded by Frank Hargraves in 1964, in Melbourne, before expanding nationally in subsequent years. The company listed in 1994, with Hargraves remaining CEO until retiring and passing the baton onto son Greg Hargraves in 2003.

A series of acquisitions during the period 2005 and 2008 saw company net debt blow out to $300m, resulting in a gearing ratio of over 50%. The financial crisis and downturn that hit the economy during 2008 severely tested the business and management was forced to restructure and raise new equity at $1.50 per share. CEO Greg Hargraves resigned in 2010 and the external appointment of current CEO Mick McMahon has restored much needed financial discipline and business rigor to the group.

With a background that includes food group Coles Group and private equity firm TPG Capital, McMahon appears to have the necessary skill sets to not only run a large people business but also financially prepare it for the more difficult times ahead. Our meetings with McMahon have impressed us but his actions to date are what counts and to that end he has not disappointed.

A no nonsense approach exemplified by a focus on cutting waste, removing a bloated corporate structure and driving greater use of technology to lift efficiency has been the hallmarks of McMahon's tenure to date. His success can be seen in the numbers, with debt levels now sitting below $70 million, net profits are set to hit a new high of over $50 million, along with higher margins and the recommencement of dividend payments.

Our view

This is a tough business, where managing people and meeting customer needs requires constant attention. That said, Skilled dominates in many segments of the market and holds long term customer contracts extending out two years for 50% of clients, with another 18% stretching beyond five years. The business requires little in the way of capital and generates significant amounts of free cash. McMahon clearly understands what needs to be done and the importance of driving more efficiency, lowering cost and keeping debt to a minimum. While Skilled will always be susceptible to the economic swings, we suggest that having placed the group on a firmer footing, the best is yet to come.

6. Super Retail Group (SUL): share price $12.25|market capitalisation $2,389 million

Background business: The story of Super Retail Group exemplifies why management can often be the difference between a business that is good and one that is great. In 1972 Reg and Hazel Rowe kicked off a mail order automotives business from Queensland. It became the forerunner to the Super Cheap Auto business that eventually expanded interstate under the leadership of Bob Thorn. The rollout model, which typifies most retail concepts today, continued well into the new decade and led to the company listing onto the stock exchange in 2004. With a listing price of $1.97, a market capitalisation of $210 million and 200 Super Cheap Auto stores already up and running, expectations were high that the best was yet to come.

The abrupt departure of respected CEO Thorn in 2006 put a temporary lid on things as investors surveyed the circumstances behind the move. However, any concerns should have been allayed with the appointment of the group's CFO Peter Birtles to the top job. Having worked with Thorn for over five years and with strong retail experience working in the UK, Birtles hit the ground running. The rollout of Super Cheap Auto continued at pace, while the newer outdoor retail offering aptly named Boating, Camping and Fishing (BCF), that began under Thorn's watch, was given more attention.

The group undertook acquisitions to provide additional scale although not everything has gone according to plan. Its move into cycling in 2008 has proven a tougher ride while the slowdown in retail conditions post the 2008 global crisis has required a greater focus on costs. And perhaps this is where Birtles and his team have really excelled. If the Super Retail Group has a key strength, it is in the way they approach their task. No big bang sales pitch but a long term consistent strategy to improve on costs and lift margins by adopting better technology and delivering on customer needs. It might sound simple but many retailers fail to jump this important hurdle.

Over the ensuing years, the group continued to lift revenues and margins. In 2011 Birtles surprised the market with the purchase of Rebel Sports from private equity for a total cash outlay of $610 million. Accompanying the buy, the group also announced a large rights issue to fund the transaction. In short, the company was asking shareholders to trust management on the merits of this purchase. Despite initial investor concerns, Birtles and his team have justifiably earned the markets applause. Birtles is quick to point out that what they have done at Rebel is simply sales 101. However, things are never that simple.

Management has shown an ability to deal with the issues of today whilst investing and preparing for tomorrow. The internet's growing penetration is both a threat and an opportunity and once again it is too early to determine how well the group is placed to deal with these issues. So far, the Super Retail Group has continued to deliver year on year, driving like for like sales growth while more established retail brands including Harvey Norman, Myer and David Jones have stumbled badly. Even more impressive, they have achieved these results with a minimum of fuss whilst maintaining a conservatively geared balance sheet. On this score alone, the group deserves the attention it now receives.

7. Breville Group: share price $5.34|market capitalisation $694 million

Business Background: If you are a whiz in the kitchen the name Breville may mean something to you. The group's website describes itself as "An Australian publicly listed company which is a leading provider of small electrical appliances in the consumer products industry." Even those less familiar with the brand would have noticed the group's stellar financial performance over recent times. However, management's commentary at the interim sounded a warning of potentially tougher times ahead. Under those circumstances it didn't take long for the market to impose its own penalty, dropping the shares from a high of $7.34. So what do we make of it?

The Breville business has history, dating back to 1957 when it operated as a small importer of basic home wares. It listed in 1999, before it was acquired by another listed group, Housewares International in 2001. The business focus shifted towards electrical appliances and in 2008, the Breville Group name was restored.

At its core, management has set a strategy, to develop premium branded products by avoiding the mass market. Products that have flowed from the group's research and development area include, the Kitchen Wizz Pro Food Processor, the YouBrew Drip Coffee Maker, and the Smart Scoop Ice Cream Maker. In addition, the group's North America operations have benefited enormously from its role as distributor of Keurig's single serve coffee brewing system.

Unfortunately success can often bring its own challenges. In the case of Keurig, the decision to cut Breville's distribution margin effectively forced Breville management to hand back the business as the economics no longer justified an ongoing investment. During the half, this business generated $12.5 million in commission revenue and for the full year close to $20 million is expected. After covering overhead costs, some $8 million is expected to flows to the bottom line. To put that into some context, Breville is forecast to generate $73 million in earnings before interest and tax for the full year, so the loss of the contract at the end of 2013 will deliver a significant dent in earnings and require management to restructure its North American operations. While this has come as a blow, it shouldn't come as a complete surprise that distribution deals can be axed, particularly successful ones. These events however reinforce the importance of building and promoting company owned brands, a point not lost on management.

Our view

Management has delivered excellent results for shareholders over a number of years. The business clearly is at a crossroads as it deals with the loss of the Keurig distribution deal. In the meantime, the group continues to invest and expand the Breville owned products. With a conservative balance sheet, carrying net cash of $50 million and a focus on delivering long term sustainable earnings, a weakening share price provides the ideal opportunity to re-examine the merits of this consumer business. ***SFM***

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Government and our big miners

It may be a strange way to think about it but what do the Federal Government and our big miners, BHP Billiton and Rio Tinto have in common? For one thing, leadership issues have been grabbing all the attention of late. In the case of both BHP Billiton and Rio Tinto we already know that Marius Kloppers and Tom Albanese have moved on, extraordinary as that may seem. One minute both are outlining long term capital expenditure budgets to coincide with ongoing resources demand and the next they are have exited, replaced by new management, now intent on conserving cash and looking to protect the interests of shareholders.

As for the Prime Minister, the omens are not looking good although a September election if she makes it that far is still a long way off. However, more startling are the deteriorating financial positions of both the miners and the Government's budget position. Having promised a return to surplus in 2013, the Treasurer has had to concede that it won't get within cooee of that target. A combination of overspending and lower revenues has forced the inevitable - belt tightening.

So rather than banking surpluses, we now need to contend with cuts, cuts and more cuts. Our two big miners are no different. Having enjoyed the fruits of a strong resources boom, capital expenditure and acquisitions have dominated the agenda at the expense of financial prudence and shareholder focus. So why have things changed so fast, surely the resources boom isn't ending tomorrow. Well not quite, but the recent sharp drop in iron ore prices was an important wakeup call that our miners couldn't ignore. As price takers, our miners have minimal downside protection should prices drop sharply, making the task of funding additional long term resource projects even more difficult.

Table 1: Financial standing of our miners

Rio Tinto	Full Year December 2007	Full Year December 2012
Sales Revenue US$'M	25,400	55,600
Net Profit After Tax US$'M	7,800	9,300
EPS US$	5.50	5.03
DPS US$ (ordinary)	1.04	1.67
Payout %	19	33
Net Debt US$'M	2,800	19,300

BHP Billiton	Full Year June 2007	Full Year June 2012
Sales Revenue US$'M	47,500	72,200
Net Profit After Tax US$'M	13,700	17,100
EPS US$	2.34	3.21
DPS US$ (ordinary)	0.47	1.12
Payout %	20	35
Net Debt US$'M	8,700	23,500

Here it helps to look back on the financial standing of both these businesses when things were cruising along. As things would have it, both Albanese and Kloppers, took over their CEO reins in May and October 2007 respectively. As the accompanying **Table 1** highlights, whilst revenues have

continued to rise, so has net debt. In the case of Rio, net profits are up from US$7.8 billion to US$9.3 billion, while net debt has increased seven fold from US$2.8 billion to US$19.3 billion. BHP fares little better, with net earnings over the period rising from US$13.7 billion to US$17.1 billion and net debt jumping from US$8.7 billion to US$23.5 billion.

In isolation even at these elevated debt levels coverage appears adequate, however, these earnings were achieved during times when mineral prices were at their peak. This is no longer the case, made worse by ongoing large capital expenditure projects that the miners are committed to fund. In ways not dissimilar to the Government, during this point of the cycle, the preferred position should have seen both Rio and BHP running conservative debt levels and a tight control on costs. Unfortunately in both instances this is not the case and the true consequences of each are yet to play out in full.

In financial markets this hasn't gone unnoticed with rating agency Standard & Poor's placing BHP and Rio Tinto on notice. In the case of BHP, the group's A rating was left intact but it did warn that with a limited buffer, action was needed to maintain this rating. For Rio Tinto the result was less favourable, with the group’s A rating revised from stable to negative. What triggered such a turnaround can be sheeted home to management making the cardinal mistake of overpaying for assets in boom times. In the case of Rio, shareholders have endured write-offs totaling a staggering $US34 billion since 2008. It is little wonder that new CEO's are ushered in at this juncture with a renewed focus on financial prudence and shareholder returns. It's clear that action was needed swiftly to address the changing economic climate, but why did it take management and the boards of both companies so long to see and do what was so obvious. Time will tell whether this Government and Prime Minister will also have to make way, having deviated so far from where they expected to be. ***SFM***

The new global war

Tensions have been rising and behind closed doors governments are in deep discussions on a war that is hard to contain and where the consequences of in-action can lead to many outcomes. We are of course talking about the global currency wars. Whether it’s the Swiss franc, the Japanese yen, the German deutschmark, the Chinese yuan, the US dollar or our own Australian dollar, there is general agreement that the gloves are well and truly off.

Enough has been said and written about the euro fallout and the economic pain that has followed. Hindsight is a wonderful thing and on reflection, whether countries such as Greece, Portugal, Italy or many others should have abandoned their own currencies for the euro appears on the surface pretty clear – no. And without wanting to get into any lengthy debates as to the pros and cons of each, the short answer from our perspective is that floating currencies allow countries to readjust to the economic conditions of the day. They act as a self correcting mechanism despite the painful process involved.

In many ways currencies reflect the underlying strength of a nation. Australia has a strong currency and while there are significant economic issues that need addressing, when compared to many other nations it appears very well placed. That said, if and when conditions deteriorate our currency

will no doubt follow suit. It's not perfect but governments that tinker with this are directly interfering with an economy's self correcting mechanism. What is often lost in the discussion process is that change is inevitable and aiming to protect industries or businesses that can no longer compete effectively without protection, is in the long run a flawed strategy. Those who argue for currency intervention are quick to denote why help is needed. Lost jobs, more imports, less domestic manufacturing are all valid reasons for assistance but who measures the benefits that restructuring brings, the re-direction of capital to more productive areas and the industries that set up and learn to compete more effectively.

Our point of view may sound sensible but it hasn't stopped countries taking action. Things really got going on 6 September 2011 when the Swiss Government stepped in to devalue the Swiss franc in an attempt to protect the economy. In pegging the franc to the euro the Swiss National Bank warned that it would no longer allow one Swiss franc to be worth more than €0.83 – equivalent to SFr1.20 to the euro. In order to achieve this, the Bank would have to purchase unlimited quantities of foreign currencies to force its value down. Having become a safe haven from the ravages of the euro zone crisis, the Swiss felt the need to act however, not everyone is convinced. Louise Cooper, markets analyst at BGC Partners, warned "that central banks do not have unlimited power – as the UK learned during Black Wednesday in September 1992."

Eighteen months on and as Graph 1 illustrates, the Swiss have kept the franc pegged to the euro. But for how long? As Cooper noted "The Japanese example with yen intervention teaches us that intervention can work in the very short term but changing long-term global currency flows is near impossible – a lesson that the UK learned from George Soros".

Graph 1: Swiss franc v euro

The danger in all this is the tit for tat mentality that invariably results when one country tries to interfere with normal market workings. This need to act and to protect is largely driven by self

interest, that governments are seen to be doing something to protect jobs and industries. Already things are escalating.

Japan, now under newly installed Prime Minister Shinzo Abe, appears determined to stimulate a moribund economy by ordering the country's central bank to be more expansionary. Governments that print money are invariably signing up for a weaker domestic currency in order to stimulate export demand. The Japanese in taking this action have sent a very clear message that they will take action to compete for business. The weakening yen is now placing pressure on neighbouring countries including the Chinese. Already tensions are high and some form of retaliation is expected. The flow on effects from currency wars are hard to quantify however it is safe to say that we should expect more of the same as each country looks to protect their own patch of the world. ***SFM***

Executive pay

It's a good thing many of our local executives don't rely on the Swiss to set their pay packets. Following on from the European crisis, executive remuneration has become a very hot topic. Top of the hit list are the bankers but what the Swiss are contemplating has far reaching ramifications and Australia may not be that far away, judging by the reaction that greeted Marius Kloppers when he recently stepped down from BHP Billiton with cash, shares and performance rights estimated to be worth $75 million.

BHP shareholders can judge whether they got value for money however, the issue of what someone should be paid and over what time frame has no easy solution. We struggle to actually understand many remuneration packages and unfortunately the annual reports of today has more content devoted to what executives are paid rather than the business itself.

We don't begrudge paying top dollar for any management team that delivers for shareholders. Alignment of interest is in our opinion the key and measuring that is not a one size fits all policy. At its core, remuneration policies should encourage management to think as owners first and foremost, rewarding performance that achieves the twin aims of protecting the existing business before seeking growth.

The new Swiss approach is still in draft form but already it has caused quite a stir. Following the financial collapse of Swissair in 2001, parliamentarian Thomas Minder has waged a personal battle culminating in a national referendum to correct what he calls the "rip off merchants". During March Swiss voters appeared to back him and the outcome, should the draft bill get up, will result in Swiss company board member mandates restricted to one year terms, salaries of executives and directors set by shareholders and not the board and certain compensation payments including sign on bonuses and payments received for takeovers banned.

It sounds quite revolutionary, but for too long investors have been paying top dollar for boards and management teams, with little skin in the game and a propensity to chase growth. Whether the Swiss have the right answer is up for debate but this is an issue that is unlikely to pass any time soon. ***SFM***

Company visit diary March Quarter 2013

January

AMA	AMA Group management conference call	23/01/13
PXS	Pharmaxis management conference call	24/01/13
RMD	ResMed Q2 2013 conference call	25/01/13
ACR	Acrux management conference call	30/01/13
CCP	Credit Corp interim results briefing	31/01/13

February

PGI	PanTerra Gold management meeting	04/02/13
NVT	Navitas interim results briefing	05/02/13
COH	Cochlear interim results briefing	05/02/13
PRY	Primary Healthcare interim results briefing	06/02/13
REA	REA Group interim results briefing	06/02/13
NWS	News Corp Q2 results briefing	07/02/13
FXL	Flexigroup interim results briefing	07/02/13
JBH	JB Hi-Fi interim results briefing	11/02/13
LGD	Legends interim results briefing	12/02/13
CRZ	Carsales.com interim results briefing	13/02/13
WOR	WorleyParsons interim results briefing	13/02/13
CPU	Computershare interim results briefing	13/02/13
SKE	Skilled Engineering interim results briefing	13/02/13
SAI	SAI Global interim results briefing	15/02/13
NHF	NIB Holdings interim results briefing	18/02/13
PXS	Pharmaxis management meeting	18/02/13
MND	Monadelphous interim results briefing	19/02/13
FWD	Fleetwood Corporation interim results briefing	19/02/13
FBU	Fletcher Building interim results briefing	20/02/13
IRE	IRESS full year results briefing	20/02/13
SEK	SEEK interim results briefing	20/02/13
AMM	Amcom Telecommunications interim results briefing	20/02/13
SUL	Super Retail Group interim results briefing	20/02/13
EGP	Echo Entertainment Group interim results briefing	21/02/13
TTS	Tatts Group interim results briefing	21/02/13
JIN	Jumbo Interactive interim results briefing	22/02/13
BRG	Breville Group interim results briefing	22/02/13
TRS	The Reject Shop interim results briefing	22/02/13
IFL	IOOF Holdings interim results briefing	25/02/13
SYD	Sydney Airport interim results briefing	27/02/13
MYX	Mayne Pharma Group interim results briefing	27/02/13
PPT	Perpetual interim results briefing	28/02/13

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March

WTF	Wotif.com Holdings interim results briefing	01/03/13
IRE	IRESS management meeting	04/03/13
APE	AP Eagers interim results briefing	05/03/13
SRX	Sirtex interim results briefing	05/03/13
CPU	Computershare management conference call	07/03/13
MND	Monadelphous management meeting	06/03/13
FLT	Flight Centre management conference call	06/03/13
DTL	Data#3 interim results briefing	07/03/13
JIN	Jumbo Interactive conference call	11/03/13
NHF	NIB Holdings management meeting	12/03/13
SAI	SAI Global site visit	13/03/13
PBT	Prana Biotechnology management meeting	13/03/13
SIP	Sigma Pharmaceuticals interim results briefing	14/03/13
SIV	Silver Chef management meeting	14/03/13
NTC	Netcomm Wireless site visit	15/03/13

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