

4 January 2007

Mr

Dear Client

Seasons Greetings.

This letter contains the financial performance for the first half of the 2006/07 financial year, being the six months 1 July 2006 to 31 December 2006.

The letter also contains:

- Profit reconciliation between accrual profit and account position balances.
- Portfolio objectives and breakdown as of 31 December 2006 with estimated dividend yields for the next 12 months.
- A copy of the online E*Trade Account Balances, Trading and Transaction Histories and Portfolio Manager positions all as of 31 December 2006.
- Portfolio review, outlook and comment.
- And an article of interest.

Financial Results for the first half of 2006/07

Your approximate gain for the first six months of the financial year ending 2007 has been + \$ (1st quarter - 1 July 2006 to 30 September 2006 + \$ and 2nd quarter – 1 October 2006 to 31 December 2006 + \$)

The following represents this:

Dividends earned during the period	\$
Franking credits earned during the period	\$
Gains on stocks/securities during the period	\$
- (Realised/Capital gains taken +\$)	
- (Unrealised gains increased by +\$)	

(Note: when a stock is sold during the period the total gain is removed and deducted from the portfolios unrealised gains and treated as a realised profit of that period, hence nothing is double counted.)

(On a full calendar year basis the 2006 year gross gain was + \$)

Profit reconciliation between accrual profit and account position balances

Here we reconcile the above six-month accrual gain with movements from the opening account balance (E*Trade stocks and cash) to the closing account balance, adjusting for any capital withdrawals or contributions and dividends/franking credits.

1 July 2006 E*trade Account Balance	\$
31 December 2006 E*trade Account Balance	<u>\$</u>
Account Increase	\$
Add back capital withdrawals	\$
-	
Subtract capital contributions	<u>\$</u>
-	
Adjusted Increase	\$
Add dividends earned	\$
Add franking credits earned	<u>\$</u>
<u>Approximate reconciled gains for the period</u>	<u>\$</u>
<i>Approximate accrual gains estimated</i>	\$

Portfolio objectives and breakdown as of 31 December 2006 with estimated dividend yields for the next 12 months

Objective Review: your portfolio objectives best meet the balanced portfolio objective.

Balanced Portfolios represent the greatest number of clients and cover the broadest client objectives. Here the portfolio consists of stable stocks, quality stocks, value stocks and store of value securities/income securities - either as a fixed percentage of the portfolio (usually 25-30%) or as a parking space while waiting for opportunities to be identified in the other sub-categories. Here the objective is to achieve capital growth and income while mindful of owning an overpriced or fully priced investment portfolio. The income generated can be reinvested or withdrawn as per the client requirements.

Stable stocks: are predominately large capitalised stocks (or holding companies with large capitalised stocks) bought/held with the aim to participate in the general market movement and bought at levels that represented value at the time. These stocks are not expected to have significant share price volatility.

Store/Income securities: are aimed at producing income and providing the portfolio with stability. The weightings are to be kept within the guidelines established unless extremely obvious equity opportunities present themselves, of which is not the case presently. Depending on the security price paid some capital appreciation could be expected.

Quality stocks: are designated to be the engine room of the portfolio. It contains stocks with some of the best business models available on the ASX along with a purchase price that represents value at the time of purchase. Best business model is defined as 1) above average profit margin, either absolute or industry relative which usually implies a strong market position and 2) low requirement of capital when expanding sales. This results in increasing profits that are available to be paid as dividends while earnings that are still growing lead to higher share prices. Sometimes these businesses are only available at a decent price when the business is going through a difficult spot.

Value stocks: are purchased because the price is low to the perceived value of the business or underlying assets. Once the share price moves to the perceived business or asset value they will be sold.

In all stock and securities categories the purchase price has to represent value ie. be purchased where there is a margin of safety between what is paid and what we receive.

ACCOUNT

\$	-	<u>STABLE</u>	amount	yield	franking	\$cash	\$franking	\$total	gross%
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
		TOTAL	\$ -			\$ -	\$ -	\$ -	
\$	-	<u>QUALITY</u>	amount	yield	franking	\$cash	\$franking	\$total	gross%
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
		TOTAL	\$ -			\$ -	\$ -	\$ -	
\$	-	<u>STORE/IN</u>	amount	yield	franking	\$cash	\$franking	\$total	gross%
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
		TOTAL	\$ -			\$ -	\$ -	\$ -	
\$	-	<u>VALUE</u>	amount	yield	franking	\$cash	\$franking	\$total	gross%
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
		TOTAL	\$ -			\$ -	\$ -	\$ -	

Portfolio Review, Outlook and Comment

I like it when I am mistaken and we still make money.

The first half of the financial year 2006/07 (1 July 06 to 31 Dec 06) has seen more of the same with the market continuing to climb higher. While things got interesting around July-September it all came to zilch and the market ended at 5669 having started at 5074. What looked like promising buy opportunities didn't materialise as those share prices drifted away (higher). Meanwhile our relatively low inactivity continues with more selling than buying (other than those who are establishing portfolios) and that buying done early in the new financial year (BCM, PBL and some Telstra for T3 swapping).

What I wasn't off the mark about was 'Being inactive isn't always dumb', something I alluded to in the EOY 2005/06 letter. The last six-month gains have been rewarding (possibly the most), especially the last three months and that is mainly due to decisions made long before July 2006 started. Many stocks we have held found favour in the market, some even being taken over, but as a group they picked up the pace.

The portfolios appear to be in reasonable shape with larger than normal holdings in income security stocks or store of value holdings (see definitions) coupled with some holdings subject to takeovers so our positions seem well hedged. Meanwhile each other individual holding has some justification for ownership and an expectation of gains through time. Because we never will know what will happen to the general market there is no point in not being invested in those businesses that meet the criteria hence our continued holdings. I am not saying their share price can't go down but that I am happy holding the positions because over time as an investor I expect to make money out of them.

Which brings me onto my next point. A friend of mine recently commented that 'you must be bullish to be in this business'. And by that he meant as a stock picker and investor a person must have an expectation that over time stock prices have to move higher. Business profits will grow over time as businesses sell (service) more widgets to more people for more money – it is a cycle that doesn't stop. I accept this point but it should come with a warning; caveat emptor - "**let the buyer beware**".

The reason for the warning is it just isn't the business operational performance that affects the share prices but the expectations of the people buying the stocks. For example as new buyers lower their desired rate of return they can pay more for the asset. If the asset price then races up on the back of this it produces high capital growth rates that in turn attracts those wanting higher returns based on price movements. It can become a feeding frenzy.

For example let's say I wanted an 8% return on my assets. I would pay \$1,250 for an asset that yielded \$100 annually ($\$100/0.08$). Suppose now that I lower my desired return on an asset to 5%. That same \$100 annual payment would now be worth \$2000 ($\$100/0.05$). Add on top of that the fact that the \$100 annual payment actually increases to \$110 because the business has sold more widgets to more people for more money and you would have the asset value at \$2,200 ($\$110/0.05$). That means the price would have risen from \$1,250 to \$2,200 or 76% in the period it took for the lower return expectation to feed through the market. By the time the asset price was up 76% you could bet your bottom dollar it would have attracted a few speculators to the market and they wouldn't have a 5% return expectation. So we have a dilemma of determining what the market has factored into the returns available from stock ownership – caveat emptor: this play also works in reverse.

So while I agree fully with my friend that I must be bullish to be in the investment game I am also tempered with the thought that stocks temporarily outperform their businesses leaving some sellers (original buyers) with outsized benefits at the expense of those they trade with. Generally, the sophisticated have the edge over the innocents in this game.

With sustained low interest rates, recent abnormal equity returns and the habit of investors making decisions while looking through the rear view mirror, is it any wonder we are seeing market frenzy. Enter Private Equity.

What is their game? Private equity players mainly use other people's capital for which they charge a fee and have override performance payments - but don't share in any downside. If they don't spend the capital they lose it to somewhere else and along with it the potential fees and bonuses. This pressure encourages them to pay way more than investors who share in both the upside and downside of a stock hence the outbidding. This pressure combined with an exit strategy based on the above-mentioned investment environment and a zero capital gains tax on overseas buyers have created the frenzy.

In summary, I remain cautious of not only the general market because all the factors pointed out in the 2006 EOY letter that remain intact (in fact copper has fallen from a high of US\$4 a pound to US\$2.65 as of last night) but also of the need to have exposure to stocks that can continue to make us money.

Finally I have included an article worthy of your attention. Naturally it is from Warren Buffett and is of a speech he gave in 1984 at Columbia Business School. So if you have managed to read this far - Congratulations - but the good stuff starts over the next page.

Happy New Year.

Yours sincerely

Justin O'Kane
Portfolio Manager

