

O'Kane Investment Services Pty Ltd
Portfolio Management
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Dear Client

Your gain for the first half of the financial year 2007/08, being the six months 1 July 2007 to 31 December 2007, before taxes and fees, has been \$ (turn to page 3 for financial numbers updated to the period ending Friday 18th January).

Reconciled back to cash

Starting 1 July 2007 E*trade Total Account Value	\$
Ending 31 Dec 2007 E*trade Total Account Value	<u>\$</u>
Account Increase	\$
Withdrawals during the year added back	\$
-	
Contributions during the year subtracted	-
-	
Adjusted Increase	\$
Add dividends earned	\$
Add franking credits earned	<u>\$</u>
<u>Reconciled gains for the period</u>	<u>\$</u>

For those with a liking of financial accounting, the yearly accrual breakdown details are as follows:

Unrealised	
- Capital Loss	\$
Realised	
- Capital gains	\$
- Dividends and interest earned	\$
- Franking credits earned	\$
- Brokerage paid	
Total Gain	<u>\$</u>

This brings your total gains since we started our association to approximately \$ (again, before taxes and fees). *All financial workings have their supporting documents included in this report.*

Portfolio Review and Discussion

Below is:

1. Review of your portfolio objective.
2. Definition of security categories.
3. Risk classification of your holdings along with estimated 2007/2008 dividends and franking credit yields as the portfolio stands at 31 December 2007.
4. Discussion.

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 The income generated can be reinvested or withdrawn as per the client requirements.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 of value/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	B							
\$ -	STABLE	amount	yield	franking	\$cash	\$franking	\$total	gross%
#DIV/0!					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
	TOTAL	\$ -			\$ -	\$ -	\$ -	#DIV/0!
\$ -	QAULITY	amount	yield	franking	\$cash	\$franking	\$total	gross%
#DIV/0!					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
	TOTAL	\$ -			\$ -	\$ -	\$ -	#DIV/0!
\$ -	STORE/IN	amount	yield	franking	\$cash	\$franking	\$total	gross%
#DIV/0!					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
#DIV/0!					\$ -	\$ -	\$ -	#DIV/0!
	TOTAL	\$ -			\$ -	\$ -	\$ -	#DIV/0!
\$ -	VALUE	amount	yield	franking	\$cash	\$franking	\$total	gross%
#DIV/0!					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
					\$ -	\$ -	\$ -	#DIV/0!
	TOTAL	\$ -			\$ -	\$ -	\$ -	#DIV/0!

What you want to know- after 10 straight days of the market being down.

What is important for this financial year hasn't been the first six months of the year but what has happened since the 1st January and continues today – and the impact and implications the falling market has on your portfolio. While the portfolio holdings and their inherent risk haven't changed this years yearly gains and losses have shifted.

The market started the year at 6275 (SP200) made a high of 6851, finished 31 December 2007 at 6340 and closed Friday at 5747 (and by the time you read this that will be out of date as well). That is a 16.1% net loss from the highs, 9.4% loss since the 31 Dec 2007 and 8.4% loss for this financial year or the last time I reported to you. So what was a financial year to date portfolio gain of \$ is now a gain/loss of \$ or %.

There is no question the market looks weak and has every chance of moving lower (just like it had from the highs). With such poor sentiment and expectations of further market and portfolio losses a fair question would be why not cut now and buy back in later. It is a good question and leads to a review of what are we trying to do in our investing.

Obviously the first problem with cutting and buying back is no one knows when the market will bottom or even if it will go down at all, and even if we are certain of its demise you have to be able to pick the bottom to be able to buy back in. If we are looking for some investment guidance then we can look no further than the same guy who told us to build arks before it rains (hence our large holdings of cash, income securities or reserves). Here he said 'it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?'

Our cash reserves permit us to initiate new holdings and add to existing positions at the lower market levels enabling our investment portfolio to recover faster than the market when it does recover.

In a bull market approximately 33% of stocks go down and as in the mirror the reflective opposite occurs in a bear market i.e. approximately 33% of stocks go up. What separates the gainers and losers is what always separates them, their future earnings performance and starting share price. So long as the earnings expectations of what we own remain satisfactory and the price at least reasonable then we can have an expectation of earnings growth and share market support even in a bear market.

While it is virtually impossible to explain market gyrations with any confidence I like to keep an eye on the long term relationship between market moves and what it is that actually causes markets to move in the first place: economic growth and resulting earnings growth. Long term the stock market can't really outperform the general economy since the stocks are businesses that operate within a capitalist economy. Hence the the last four years share price growth is a combination of catching up from below par 2001-03 levels to overshooting 2006-07 levels. This pullback most likely reflects some sort of reversion to the economic mean but what is unknowable is 1. Are we there yet or 2. Will it keep going. Here an educated guess will have the same probability of success as a random one – people with crystal balls usually live in caravans.

Specifically to the portfolio, I continue to remain comfortable with the holdings even during these times of pressure. If there is one holding I have been disappointed with it has to be BBC (Babcock and Brown Communities). This was bought with an expectation it would provide stability to the portfolio and a decent yield (8.2% capital deferred at purchase and 11%+ today). The market reality has been the opposite as it has been caught up in the sell off of stocks that require debt refinancing even though it appears not to be a BBC problem. It has been a bitterly disappointing portfolio performer given its objective – yet the business as a whole remains sound and the value gap has widened with the capital deferred yield over 11% now. Like BBC the rest of the stocks moves are the results of increased share price volatility – not anything operational.

As a result of this market sell off the forecast gross yields being generated within the portfolio holdings are at levels not seen in a few years, which is interesting. Either the share prices are too low or the dividends are unsustainable or the required rates of return (interest rates) are staying high(er). Most likely it is a function of all three in unknowable percentages. Either way our core holdings are attractively priced for their prospects to not want to give away predictable long-term futures because of short-term worries.

The issue that started most of the market panic, sub-prime mortgages, has not affected us directly but indirectly has had an effect on our portfolio construction. In financial markets the cost of credit has blown out considerably because the bottom end of home loan borrowers started forfeiting on their home loan obligation in the USA. This had a chain effect on the cost of credit all the way up the credit ladder causing all debt to become more expensive to obtain (higher interest rates). Any existing fixed debt

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obligations dropped in value as they could now be issued/sold at higher interest rates i.e. yield better from an investors point of view. For our portfolios it became safer to hold cash rather than some income securities as their prices had to readjust for the higher market expectations. The exception to the rule is 1. Short term maturing securities whose value can't shift too far because of the maturity and 2. Floating rate notes whose yield is a combination of fixed rate over the 90-day bank bill. And because the 90-day bank bill reflects both Reserve Bank risk free rates and the cost of credit it automatically adjusts for the credit blow out in favour of the investor. So in fact it works to our favour as we now pick up a higher yield (a bit like the banks putting up their interest rates without official rates moving).

It is a timely reminder that there is a difference in investing between the portfolio market value going down and permanently losing money. While rule one is not to lose money and rule two is not to break rule one, money is permanently lost when securities are bought and either 1. The business operation permanently changes such that the operating capacity will not allow for future earnings or drastically reduced earnings (cyclical business are particularly effected here) or 2. The price paid for the security was so high such that so much time will need to pass before the price paid is justified (great businesses where people say there is no price too high to pay for it are effected here). So money can be lost because the business does poorly and/or the price paid was too high even if it is a good business earning well. Both of these risks have been present in the market and we are seeing the effect of many people waking up to them. Permanent loss does not occur when good businesses are purchased at reasonable prices.

Market Observation

In the last 18-24 months the market has had significant volatility; having risen from 5000 (SP200) up 1,430 points back 950 points then up 1,370 and now down 1,200 points. That is an accumulation of 4,950 points or nearly 100% of the market capitalisation. Moves of this nature almost guarantee that recent market participants over that period are not showing capital gains. Given human nature to buy when things look good and sell when things look bad we have seen a breeding ground for disappointment, especially the last bull trap rally. From March onwards we will see companies report expectations for the full year and while the market has lost its upside exuberance it will be interesting to see what emotion follows that news. While more market disappointment might hurt portfolio returns over that period for the investor who likes buying cheap your day is coming.

Kind regards

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Portfolio Manager