

7 January 2010

Dear Client

Twelve months ago in the client report for the six months ending 31 Dec 2008, I wrote that it was a bit hard to know where to start the report because of the mixed situation of a down period for our portfolios, but plenty of opportunity abounding. Well, there is no such problem with this six month report ending 31 Dec 2009, as the diagnosis is the simple fact that the market went up - and we didn't miss out. And like Oliver Twist, we now ask the question, "Please, sir, I want more."

The market started the financial year, 1 July 2009 at 3955 and closed 31 December 2009 at 4870 for a gain of 23.1%. Add dividends and franking credits and a portfolio 100% invested in stocks only would have returned approximately 25.5%.

This letter contains the results for your portfolio for the six months, but only reconciled on a cash basis, as the unrealised gain/loss (on securities bought but not yet sold) figure needed for accrual accounting was unavailable from E*Trade at the crucial 31 December cut off. The effect being, I was unable to cross reference the cash result with the accrual result and instead of being 99.9% confident of the accuracy I am only about 99% confident. This will be rectified for the end of financial year report. If you are ever going to call me with an error this is your chance.

The letter also contains print outs of end of period balances, trading history, cash transaction history and dividends – being all the reports needed to reproduce the portfolio result. Also, there is an objective review and a position summary report (consolidated for multi account clients) with future dividend estimates that I normally use for internal purposes but am now making available.

Results for the 1st Half of 2009/2010

Cash reconciliation

| | | |
|---|----|---|
| Closing E*Trade account balance on 31 December 2009 | \$ | - |
| less | | |
| Opening E*Trade account balance on 1 July 2009 | \$ | - |
| E*Trade account balance change for the six month period | \$ | - |
| <i>less</i> | | |
| Contributions made in the period* | \$ | - |
| <i>add</i> | | |
| Withdrawals made during the period* | \$ | - |
| <i>add</i> | | |
| dividends and franking credits earned during the period (excludes dividend reinvestment) | \$ | - |
| TOTAL net GAIN for the period | \$ | - |

* contributions/withdrawals explained

less contributions of cash into E*Trade ANZ CMT (incl div if any) \$0
less contributions to E*Trade via share purchase plans \$0
add back withdrawals of cash from E*Trade ANZ CMT \$0
add back withdrawals via stock maturing and cash returned to you \$0

note: interest received and brokerage paid are included in E*Trade account balances

Markets & Portfolios Reviewed

2009 - Experience the difference

If you have ever been watching a game of footy on TV, and the team losing badly at half time comes back to win the game in the second half, then the commentators for sure will be calling it a game of two halves. Bruce McAveney might even refer to the Dr Jekyll and Mr Hyde characteristics of the game. So it was with the stock market in 2009. By March, the market had reached an ear piercing crescendo of pessimism, yet by December all seemed forgiven and just about forgotten as the 50% correction was replaced with a 50% rally - the only thing missing being the 2000 points from the previous market highs!

While it is good to survive such market volatility, the issue is what we can gain from this market experience. Remember, there is a difference between gaining experience and experiencing something - the guy who says he has 20 years experience at some task could really just have one years experience 20 times. In investing we don't want to be this guy. Here I am reminded of a Bart Cummings's one liner – ***“you can't buy experience you've got to earn it. I've earned a fair bit and it's starting to work.”***

What never changes, come the beginning of a new calendar year, is the incessant need by nearly all publications that have anything to do with financial reporting to let rip with their best guesses of what will happen in the market over the next 12 months. If you have been a client of mine long enough, or read enough of these letters, you will know I won't be looking into my crystal ball. Instead, I simply refer you back to the generic market valuation on page 9 of the last client letter i.e. EOFY (End of Financial Year) 2009, now available on okis.com.au. All that appears to have happened is the desired return investors require has reduced from about 10% to about 7.5% as they morph back to Dr Jekyll from Mr Hyde (remember as the market rallies the dividend yield decreases). The true underlying value of the market changes at a snail's pace (around GDP) so for the market to further rally or plummet significantly it comes down to whether we see further optimism or renewed pessimism. I don't know how I'll be feeling in a year's time, let alone everyone else.

Instead, at this time of year and after the experience of the last 12 months rollercoaster, it may pay to just remind ourselves of what it is we are striving to achieve as investors.

At OKIS our investment philosophy and resulting processes and decisions are based on trying to achieve this simple (but not easy) goal Warren Buffett suggested investors aim for.

“Our Goal as investors should simply be to purchase at a rational price a part interest in an easily understandable business whose earnings are virtually certain to be materially higher 5, 10 & 20 years from now. Then, put together a portfolio of companies whose aggregate earnings march upwards over the years” Warren Buffett

I have this statement stuck up on my wall in my office and it is my favourite Buffett comment – and you know I have read a few. This line isn't funny or witty but it does go to the heart of investing and during the desperate and then recovering times of 2009, I constantly referred to this quote for reassurance. It is worth understanding.

At the heart of the statement it says we need investments that will have *materially higher* earnings 5, 10 & 20 years from now and this is simply because higher future share prices ultimately reflect higher future earnings. Therefore, if we want to see portfolio appreciation, there needs to be increases in the earnings of the companies we own through time. Note, the comment says nothing about today's earnings or even next years (which incidentally is where the broad market participants focus), but instead 5, 10 & 20 years from now, so that means the medium to long to very long term.

Next it says those earnings need to be *virtually certain* of being *materially higher*. So how is this achieved? There is only one way that I know and that is for the business or stock in question to have a competitive advantage that is sustainable. The competitive advantage means that more customers buy from this company compared to another for the reason that they sell their goods and services for cheaper prices, or alternatively their product/service are superior (rarely is it for both). Sustainability means simply that the advantage isn't fleeting or due to short term circumstances. So we study the business strategy of a stock to determine if it has a sustainable competitive advantage that can be exploited for years to come. This is the surest way to be certain of materially higher earnings in the years ahead.

With regard to price, we need only pay *a rational price*. It is with price that most investors fall down as they proxy value for price and interpret a lower stock price as a poor value deteriorating business. While this can be the case it isn't always.

A rational price implies we pay an amount for the stock that will yield a return via dividends and capital growth that meets our investment return objectives. It is the certainty of this happening via the exploitation of the sustainable competitive advantage that provides the level of comfort needed.

Next *put together a portfolio* of these companies because (and I can only assume here) it won't be smooth sailing for all companies all the time, but as a group their *aggregate earnings* should *march upwards over the years* ensuring a higher portfolio value. A portfolio full of these types of businesses then provides the diversification needed.

Late 2008 and early 2009 threw up some of the most 'rational' pricing that there has been for many years.

Our objective then continues to be to implement this advice regardless of day of the year, market level, sentiment, interest rates, economic growth etc so long as we believe the earnings of the companies we are looking at are going to be materially higher 5, 10 & 20 years from now.

Old but good

The above approach is old fashioned and almost boring, but having recently read Bart Cummings autobiography (yes – a Christmas present), I'm convinced the older and less fashionable our approach becomes, the better it works.

With Don Bradman like out-performances in their relative fields, I was surprised by how similar Buffett and Cummings are in their styles and approaches. Buffett is 80 years old this year and Cummings is 81, so both were born during the depression periods of the 1930's. What strikes as intriguing is that they both have basic philosophies that haven't changed over time, while society has shortened its focus – in financial markets and company reporting it has become quarterly driven out-performance, and in racing it is quick returns on two year old racing. While everyone else scrambles for short term success, they keep on racking up milestones by executing old fashioned principles.

I am reminded in the Cummings book of the significance to sticking to time tested principles and what they say you should focus on and equally as important, by exclusion, what is not of importance. Cummings has publicly stated his success is built on what his father taught him, whom like Buffett's mentor Benjamin Graham, experienced the worst of the depression. A perfect illustration of how to interpret a core principle took place at a 1964 yearling sale. To quote from the book:

“In spite of his good breeding, this bay yielding colt was likely to come at a bargain price. He threw his offside foreleg out at an angle, and was distinctly pigeon-toed. People said he walked like Charlie Chaplin. But that didn't discourage me, because it didn't contradict any of the principles of spotting yearlings that my father had taught me....According to all these criteria (if you want to know the criteria you will have to read the book), Galilee was a good buy. There was nothing in Dad's principles about a yearling needing to have perfect conformation. The perfect horse hadn't yet been bred. Some buyers fall into the trap of seeking perfection and being turned off by any minor idiosyncrasy. Not me.”

Needless to say the horse went on to win the Melbourne and Caulfield Cups and Cummings considers it the best horse he has trained to date.

The point of the story for us is to understand that what is important about a principle is not just what it says we should focus on but by default of what is excluded, what we should not be distracted by.

Testing our portfolio

Turning back to our equivalent principle, while it was reasonably simple to explain, it is far from easy to do for reasons ranging from the need to identify a business's strategy and understand its durability, to being able to buy patiently or even better, buy under pressure.

A detailed discussion of each company's competitive position and its sustainability is beyond reach here, but we can observe each company's historic long term earnings growth (or lack of it) in earnings per share (EPS) and compare it to when we first started buying the stock. This will give us a glimpse to see if the company is living up to expectations as described by Buffett.

The list below is the EPS for stocks we own or have owned over different stages. As you read through the list, for the period(s) we have owned them, some have failed or are failing the test, others have succeeded or are succeeding, and some are yet to earn their stripes.

What is interesting about the table is that most of the companies don't have earnings that are smooth; most don't have earnings that go up every year; many have experienced a down year in 2009 and 2010 is uncertain etc, but none of this is stated as important in Buffett's advice, or a reason not to own the stock if they meet the rest of the criteria.

From an earnings perspective, the principle says we need higher earnings 5, 10 & 20 years from now. So if we back test since our ownership, many we own have higher earnings than they did years earlier and that is after using the 2009 earnings downturn. For some businesses, witness the recent low in earnings is higher than the previous low in earnings. I have highlighted these years in large italics. Making higher lows in EPS is one of the most compelling signs that they are doing something right as they move through each earnings cycle.

As a group there is some comfort to be had that we may meet Buffett's goal for investors in the future.

| | | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|------------|------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| HVN | EPS | 10.8 | 10.2 | 12.3 | 14.3 | 16.7 | 16.2 | 19.2 | 24.6 | 27.7 | 23.6 |
| | DIV | 3.5 | 4.0 | 4.5 | 5.0 | 7.5 | 6.5 | 8.0 | 11.0 | 14.0 | 11.0 |
| SGN | EPS | 6.4 | 9.2 | 11.3 | 14.4 | 14.6 | 14.1 | 16.1 | 18.6 | 19.4 | 17.6 |
| | DIV | 2.9 | 6.3 | 6.6 | 11.2 | 12.1 | 12.1 | 26.5 | 13.2 | 10.8 | 7.2 |
| IFM | EPS | 2.6 | 4.0 | 4.5 | 5.6 | 6.4 | 4.5 | 5.6 | 4.7 | 4.0 | 3.3 |
| | DIV | 0.0 | 2.5 | 2.8 | 3.4 | 3.8 | 3.4 | 11.0 | 7.5 | 3.2 | 2.8 |
| FLT | EPS | 49.2 | 51.8 | 71.1 | 76.4 | 89.4 | 71.9 | 84.5 | 96.6 | 146.5 | 98.0 |
| | DIV | 24.9 | 87.4 | 37.4 | 43.5 | 61.0 | 50.5 | 52.0 | 66.0 | 86.0 | 9.0 |
| ARP | EPS | 9.1 | 11.4 | 13.1 | 16.3 | 19.2 | 21.8 | 20.2 | 23.7 | 29.5 | 33.9 |
| | DIV | 4.4 | 25.0 | 6.5 | 8.0 | 9.5 | 30.5 | 11.5 | 13.0 | 15.0 | 16.5 |
| PTM | EPS | | | | | | | | | 27.8 | 21.7 |
| | DIV | | | | | | | | | 24.0 | 20.0 |
| MQG | EPS | 124.3 | 138.9 | 131.9 | 163.1 | 229.3 | 323.9 | 382.3 | 569.8 | 653.5 | 308.6 |
| | DIV | 86.0 | 93.0 | 93.0 | 143.0 | 122.0 | 201.0 | 215.0 | 315.0 | 345.0 | 185.0 |
| CXP | EPS | 7.6 | 13.3 | 16.8 | 22.8 | 26.0 | 30.3 | 35.1 | 36.4 | 39.3 | 36.8 |
| | DIV | 2.5 | 4.5 | 6.0 | 8.0 | 13.0 | 15.0 | 18.0 | 21.5 | 26.5 | 26.5 |
| COH | EPS | 48.2 | 60.2 | 83.4 | 109.9 | 91.4 | 107.5 | 145.2 | 180.1 | 206.6 | 233.2 |
| | DIV | 30.0 | 41.0 | 51.0 | 77.0 | 79.0 | 80.0 | 100.0 | 125.0 | 150.0 | 175.0 |
| BBG | EPS | 0.0 | 20.2 | 28.7 | 35.9 | 40.8 | 58.3 | 67.3 | 77.0 | 81.2 | 65.4 |
| | DIV | 0.0 | 12.4 | 18.1 | 22.4 | 25.3 | 36.3 | 42.0 | 48.2 | 53.0 | 45.0 |
| RHC | EPS | 7.8 | 14.5 | 24.0 | 28.9 | 32.6 | 29.7 | 46.1 | 54.6 | 59.1 | 74.1 |
| | DIV | 7.4 | 8.5 | 11.0 | 15.5 | 17.5 | 20.0 | 24.0 | 29.0 | 32.5 | 38.0 |
| TLS | EPS | 31.4 | 34.6 | 28.4 | 35.2 | 32.6 | 34.8 | 25.7 | 26.2 | 29.8 | 32.9 |
| | DIV | 18.0 | 19.0 | 22.0 | 27.0 | 26.0 | 40.0 | 34.0 | 28.0 | 28.0 | 28.0 |
| WBC | EPS | 87.7 | 101.9 | 107.9 | 115.3 | 127.7 | 143.3 | 165.7 | 185.3 | 196.7 | 123.2 |
| | DIV | 54.0 | 62.0 | 70.0 | 78.0 | 86.0 | 100.0 | 116.0 | 131.0 | 142.0 | 116.0 |
| NAB | EPS | 204.8 | 248.1 | 228.3 | 243.6 | 211.5 | 224.7 | 251.0 | 268.4 | 260.9 | 122.5 |
| | DIV | 123.0 | 135.0 | 147.0 | 163.0 | 166.0 | 166.0 | 167.0 | 182.0 | 194.0 | 146.0 |
| ANZ | EPS | 98.8 | 111.1 | 130.3 | 141.3 | 145.1 | 159.5 | 188.6 | 204.8 | 147.8 | 166.5 |
| | DIV | 61.2 | 69.7 | 81.2 | 90.8 | 101.0 | 110.0 | 125.0 | 136.0 | 136.0 | 102.0 |
| WOW | EPS | 32.4 | 40.2 | 49.3 | 57.2 | 66.6 | 75.4 | 90.3 | 107.8 | 133.5 | 149.7 |
| | DIV | 23.0 | 27.0 | 33.0 | 39.0 | 45.0 | 51.0 | 59.0 | 74.0 | 92.0 | 104.0 |

Warning: Don't be fooled into thinking all we need do is find companies who have historical EPS growth as the reason behind the growth needs to be sustainable – the reason for the past success needs to be repeatable.

What is certain is that the key principle by which we make our decisions at OKIS is as firm as ever.

Finally as we enter 2010 I would like to wish everyone a prosperous decade and I look forward to being part of your success.

The final word belongs to Bart Cummings who said "Remember, it might take intelligence to be smart, but it takes **experience** to be wise."

Yours sincerely

Justin J O'Kane, CFA

P.S Please feel free to take a look at the updated website okis.com.au or refer it to a friend.