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Dear Client

Welcome to the 2014/15 interim client financial report. Included within this letter are the financial year to date portfolio returns, transactional reports and market/portfolio commentary.

Over the last six months, being the financial year to date and the period covering this financial report, the S&P ASX200 gained 0.3% while interest rates averaged 2.85% pa. I am pleased to say that our investment portfolios have had superior gains and even handsomely outperformed for the great majority of accounts that don't carry mining or energy exposure.

Market Commentary –Part I

Despite the usual litany of global and local financial crises the general market, as measured by the S&P ASX200, gained 1.1% in 2014. Since last January we have witnessed the pro-Russian unrest in the Ukraine, an Ebola scare, the emergence of ISIS and further Middle East unrest, a collapse in the iron ore price, a collapse of the oil price, some short lived German crisis (wasn't in soccer), the ending of quantitative easing, strengthening of the US economy, release of the Murray financial report and the Russian Ruble crisis to name just a few easily remembered events. The net result of this flurry of uncertainty was a market that effectively didn't shift.

I'm not saying these events shouldn't be perceived as important, but when we can't even foretell the true long term market impact of an individual event with any certainty, then what chance do we have of forecasting the combined impact of a series of future unknown events? The only thing more fruitless than asking what the market will do in the next twelve months is the answer someone may give. Pundits offering to make a 2015 market

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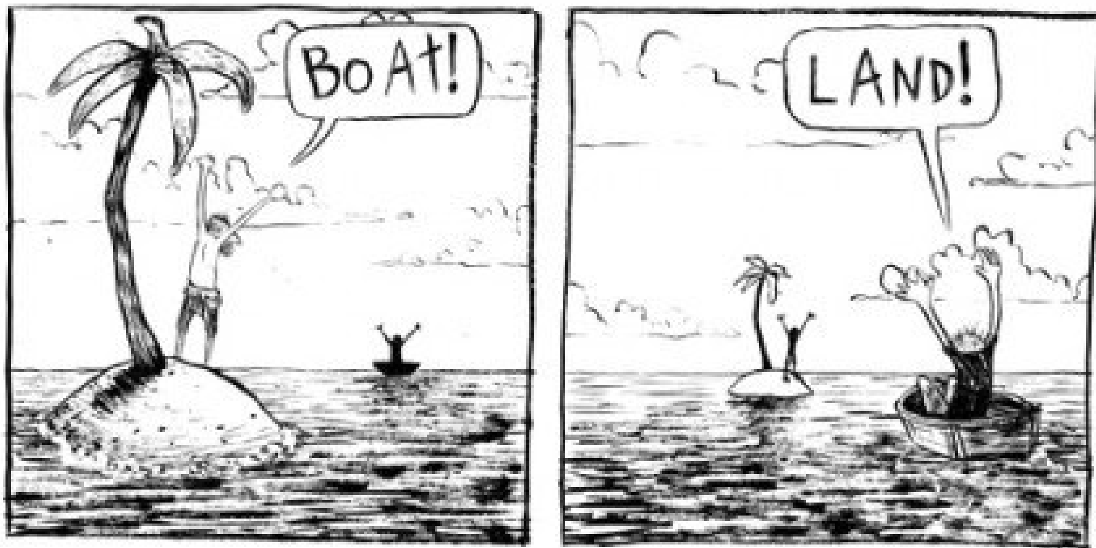
prediction based on forecast economic influences should be committed to undertake a Rorschach test.

Market Commentary –Part II



Recently I came across this astute illustration on the wisdom of perspective. It has relevance to investing but any elucidation depends on one's starting point.

While market participants may drift from the importance of growing cash flows (think rising dividends) they ultimately return to seek those cash flows. Clients familiar with past reports will recall a better (but still limited) general market perspective can be gleamed by analysing value through the trailing market yield and then making allowances for the quality of the underlying dividends supporting the market yield. Such a review won't inform of the next market direction but it will convey if the market is at risk to price movement.

The caveat emptor to this equation is any suspect dividend period (think 2006-2007) introduces value uncertainty and all valuation bets (guidelines) are off. With the ASX heavily biased towards banks and mining stocks, special emphasis is needed towards the economics of these two industries to test dividend/earnings quality.

As a rough guide, any market trading on a high yield (5%+, usually through lower stock market prices) with robust earnings supporting the market dividends is usually a good bet

for market dips to be supported, short lived or even a following rally. While a low yielding market (sub 4%, associated with much higher market levels) with suspect dividends guarantees risk to a market correction for which share prices likely won't be ultimately supported. A 4% to 5% yield disparity may not sound much but it equates to a market rally or fall of about 10% in either direction from today's 5435 S&P ASX200 before either yield is seen.

Today's market yield is approximately 4.6%, so assuming normal growth expectations, I would be satisfied with today's general market level as being an attractive investment position. But, as flagged, the quality of the underlying dividend needs assessment. This may prove to be a challenge as there are two major concerns originating from the two largest market sectors; banking and mining/energy.

Banking

The four major banks contribute a meaningful percentage (35%) to the markets overall capitalisation and dividends. Should bank dividends either fall or not grow then the ability of the overall market to raise will be impacted. The Murray report qualified what a lot of people already believed; that the banks need to hold more equity (mainly retained profits) to ensure that during any future financial crisis they are well enough capitalised to continue to attract foreign investment funding (which predominantly fund the housing loans made) and not again become reliant on the Federal Government to guarantee their obligations.

The big four banks have been gradually lowering the amount of shareholder capital they hold in the event of housing loan defaults. Once upon a time the big four held 50% of 8% of any housing loan as capital in case of default. That is $4 of equity for any $100 worth of loans. The other $96 came from bank borrowing i.e. local deposits or bonds issued overseas. Recently CBA, Westpac, ANZ and NAB have been holding as little as 15% of 8% of any housing loan or $1.20 of equity for every $100 in housing loans. No one is saying the banks are about to become insolvent but many people are acknowledging the banks will be in strife if we have a housing crash and there is a financial crisis.

The consequence of this realisation is the major banks need to raise additional shareholder equity of somewhere between $20 billion and $50 billion. The obvious source is the $20 billion in dividends they annually distribute. The banks are going to have to find equity capital from somewhere. Even if the major banks continue to grow their profits, investors

face either lower dividend pay-out ratios or dividends being reduced or underwritten, or some other equity issuing and hence dividend dilution per share. Either way I struggle to see how the per-share dividends of the major banks can contribute to a higher valued market over the next 18-24 months. In other words, the banks equity dilemma may be problematic in the short to medium term.

Mining and Energy

Unlike the large banks whom need to resolve a potential problem, the miners and energy companies whom make up 20% of the overall stock market face an immediate problem; the collapse in the price of the commodities. Lower profits should lead to lower dividends. The last time BHP cut its dividend was in 2003 and that was by 10%, not catastrophic but neither value accretive to the overall market.

When we combine the issues facing the major banks and the mining/energy industries, it is not unreasonable to be cautious as to the quality of the overall current market dividend. While I don't expect today's dilemmas to be sufficient to cause underlying dividends to dramatically fall (during the GFC the overall market dividend only fell 20%), there is a chance the discussed issues result in some kind of hand-break on the ASX's ascent. If the market was much higher (yielding 4% or less), I would be worried about a meaningful correction, but off a starting 4.6% yield, any meaningful market dip is likely to be bought back and we may even end up just passing further time at these levels. Not all market sectors are struggling after all.

Portfolio review

The tables below display the half year dividend histories for the most commonly held stocks in client portfolios. Rather than provide a half year running commentary on what just happened or might happen I thought it would be more interesting to illustrate current trends though the company dividends. I find it most useful to run my eye up from the bottom number for each half year dividend separately as this removes the seasonal distortion some businesses experience.

Of interest in the tables as you run up the line of each half year should be the dividends directional trend and the pace of change in the dividends. You will quickly observe which businesses are doing best, which have improved or slowed and those that are besieged.

The description splitting the two groups relates to the purchasing behaviour of the business's customer. A 'stable' business is one in which the buying habits of the customer are reasonably consistent through time in terms of volume purchased and price paid for items. In a stable business we expect the dividend to behave in exactly that way; stable growth. While a 'variable' business has customers whose buying routines and the prices they're prepared to pay for goods and services are less predictable. I've shown 'variable' businesses with longer dividend histories to exhibit the cyclical nature of their operations and where we are in the cycle.

Stable Businesses

Brambles Dividends Per Share (cents)

Period Ending	First Half	Second Half	Full Year
6/30/2014	15.1	13.5	28.6
6/30/2013	12.5	13.5	26.0
6/30/2012	12.8	13.0	25.8
6/30/2011	13.0	13.0	26.0
6/30/2010	12.5	12.5	25.0

Coca Cola Amital Dividends Per Share (cents)

Period Ending	First Half	Second Half	Full Year
12/30/2014	20.0	--	--
12/30/2013	24.0	32.0	56.0
12/30/2012	24.0	32.0	56.0
12/30/2011	22.0	30.5	52.5
12/30/2010	20.5	28.0	48.5

Woolworths Dividends Per Share (cents)

Period Ending	First Half	Second Half	Full Year
6/30/2014	65	72	137
6/30/2013	62	71	133
6/30/2012	59	67	126
6/30/2011	57	65	122
6/30/2010	53	62	115

Wesfarmers Dividends Per Share (cents)

Period Ending	First Half	Second Half	Full Year
6/30/2014	85	105	190
6/30/2013	77	103	180
6/30/2012	70	95	165
6/30/2011	65	85	150
6/30/2010	55	70	125

Invocare Dividends Per Share (cents)

Period Ending	First Half	Second Half	Full Year
12/30/2014	15.8	--	--
12/30/2013	15.0	19.5	34.5
12/30/2012	15.0	19.0	34.0
12/30/2011	13.5	16.2	29.8
12/30/2010	13.0	15.2	28.2

Cochlear Dividends Per Share (cents)

Period Ending	First Half	Second Half	Full Year
6/30/2014	127	127	254
6/30/2013	125	127	252
6/30/2012	120	125	245
6/30/2011	105	120	225
6/30/2010	95	105	200

RHC Dividends Per Share (cents)			
Period Ending	First Half	Second Half	Full Year
6/30/2014	34.0	51.0	85.0
6/30/2013	29.0	41.5	70.5
6/30/2012	25.5	34.5	60.0
6/30/2011	22.5	29.5	52.0
6/30/2010	18.5	25.0	43.5

Telstra Dividends Per Share (cents)			
Period Ending	First Half	Second Half	Full Year
6/30/2014	14.5	15.0	29.5
6/30/2013	14.0	14.0	28.0
6/30/2012	14.0	14.0	28.0
6/30/2011	14.0	14.0	28.0
6/30/2010	14.0	14.0	28.0

Westfield Dividends Per Share (cents)			
Period Ending	First Half	Second Half	Full Year
12/30/2014	26.2	--	--
12/30/2013	25.5	25.5	51.0
12/30/2012	24.8	24.8	49.5
12/30/2011	24.2	24.2	48.4

Variable Businesses

Harvey Norman Dividends Per Share (cents)			
Period Ending	First Half	Second Half	Full Year
6/30/2014	6.0	8.0	14.0
6/30/2013	4.5	4.5	9.0
6/30/2012	5.0	4.0	9.0
6/30/2011	6.0	6.0	12.0
6/30/2010	7.0	7.0	14.0
6/30/2009	5.0	6.0	11.0
6/30/2008	7.0	7.0	14.0
6/30/2007	5.0	6.0	11.0
6/30/2006	4.0	4.0	8.0
6/30/2005	3.0	3.5	6.5

Macquarie Dividends Per Share (cents)			
Period Ending	First Half	Second Half	Full Year
3/30/2015	130	--	--
3/30/2014	100	160	260
3/30/2013	75	125	200
3/30/2012	65	75	140
3/30/2011	86	100	186
3/30/2010	86	100	186
3/30/2009	145	40	185
3/30/2008	145	200	345
3/30/2007	125	190	315
3/30/2006	90	125	215

Platimum Asset Management Div PS (cents)			
Period Ending	First Half	Second Half	Full Year
6/30/2014	14	20	34
6/30/2013	8	14	22
6/30/2012	8	13	21
6/30/2011	10	15	25
6/30/2010	8	14	22
6/30/2009	8	12	20
6/30/2008	12	12	24
6/30/2007	0	--	0

If you are asking yourself if the market price changes reflect the trends and swings in the dividend tables above the answer is likely yes. Consequently you now have a good handle of how the share prices have fared recently.

On the separate question of currency exposure we have maintained favourable exposure to a lower Australian dollar across the equities portfolios for a number of years now. I expect the recent Australian dollar weakness to boost the operating results of many of our businesses now that weakness has materialised.

I remain comfortable with the client portfolios and valuations aren't excessive despite some stocks experiencing price increases. This doesn't guarantee that our stocks won't experience price decreases, but we own some terrific businesses trading at sensible prices. The search for new stocks that exhibit the business characteristics that offer us the highest chance of future dividends and capital growth will continue into 2015 with earnest.

Master of its own destiny

Bunnings is a good business and everybody knows it. In fact, if Bunnings wasn't owned by Wefarmers and instead separately listed on the ASX I am sure we would own shares in it. How good a business is Bunnings? Over the last 20 years Wesfarmers has made a net investment of $3.3 billion building Bunnings and today reaps almost $1 billion dollars of annual earnings (before tax) from that investment. That equates to a 30% annual return on Wesfarmers original investment. But it gets better. Not only does Wesfarmers make 30%

annually from its original investment in Bunnings but Wefarmers can make further investments to grow Bunnings that also generate 30%+ returns on the new capital spent. Assuming Wesfarmers was to invest a new net $300 million each year (and pocket $700 million of last year's earnings) at a 30% return Bunnings would generate an additional $90+ million in profit annually.

You can almost count on one hand the number of ASX listed businesses that have the kind of sustained financial metrics that Bunnings exhibits. For a long term investor wanting to own a business that can pay the majority of earnings as dividends and still grow earnings at above average rates Bunnings (standalone) is a Holy Grail of investments. The aspect I like best about Bunnings financial success is the near certainty of it occurring from the outset.

In what I consider the greatest investment book written 'Competitive Strategy: Techniques for Analysing Industries and Competitors', Michael E. Porter sets forth the industry conditions necessary and the appropriate operating strategy a business need employ to earn sustained excess returns on capital. Remember, stocks that generate sustained excess returns on incremental capital spend are the only stocks that can both yield attractively and grow their share price consistently for long stretches of time. Twenty years ago Bunnings had four stores and the Australian hardware/home improvement market was fragmented without a meaningful market leader. Porter outlines that for a dominant and highly profitable player to emerge, an industry must be susceptible to a market leader emerging that can shape industry events.

Twenty years ago the hardware/home improvement market was indeed susceptible to the emergence of a leader who could introduce economies of scale in purchasing power, marketing, distribution and supply chain. The larger Bunnings became, the cheaper it could purchase from suppliers, the further it could spread its fixed costs, the more it could promote its offering; with much of this efficiency passed to the customer in the form of even cheaper goods. Once Bunnings established this efficiency cycle there was not much the rest of the fragmented market players could do. The advantage Bunnings has created in servicing customers is also the competitive disadvantage facing incumbent competitors, suppliers and anyone thinking of entering the industry. Fast forward twenty years and Bunnings now operate 223 warehouses selling $8.5 billion annually in a market estimated to be worth $47 billion and growing at 5% per annum. Until recently this was all done without a natural competitor.

Just as Porter's framework identified the emergence of Bunnings and its sustained business success, Porter's analysis can be used to assess the wisdom of Woolworths entering the hardware/home improvement industry with Masters. In fact it is the telling way to evaluate the decision.

It would not be unreasonable to assign Bunnings a standalone valuation of $15 billion dollars. If so, Wesfarmers has spent a net $3.3 billion creating $15 billion dollars of Bunnings value, or put another way, for every $1 of net capital spent, $4.50 of value has been created. This kind of value creation, a kind of financial alchemy, usually attracts competition for a piece of the action. This is especially true when the market leader only has about 20% of the pie. With 80% of the hardware and home improvement market available for an efficient operator generating large returns on equity, there is a prize for any player who can get established. Even better, Australia is a proven natural harbor for duopolies. Just don't be third.

With the industry now having a dominant market leader according to Porter's analysis the biggest impediment to the emergence of a new major player in the hardware/home improvement sector would be "the need to invest large financial resources particularly if the capital is required for risky or unrecoverable up-front advertising…Capital may be necessary not only for production facilities but also for things like inventories or covering start-up losses".

In order to compete with Bunnings, the capital injection requirements may need to be $3.0-$5.0 billion to get the scale needed to generate 20% plus returns on capital. Who in Australia has the access and the will to risk that kind of money in joining Bunnings? Of all the companies throughout Australia who could contemplate such a commercial endeavor I can only think of one company that comes close; Woolworths. The simple fact is this opportunity is Woolworths alone, even if others had wanted to undertake this endeavor they couldn't afford the risk. In other words Woolworths has no other natural competitor to this opportunity and that materially decreases the risk of poor returns. To even further dissipate the risk, Woolworths has partnered with one of the most successful hardware/home improvement players in the USA, Lowes, who already compete head to head with the original Bunnings, the Home Depot.

Woolworths is the one business that can breach the capital requirement barrier to entry and ultimately Masters will find itself also protected by the same barrier as Bunnings.

Bunnings economic success wasn't overnight and neither will Masters be. In a world of instant gratification and easy money, it can be forgotten that good businesses are the result of often unique circumstances, hard graft and competing against a majority of poorly positioned competitors.

Finally I wish everyone the best for the New Year and if you are travelling for holidays that it is both a safe and enjoyable break.

Regards

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