

9 July 2007

Dear

Your gain for the financial year ending 30 June 2007, before taxes and fees, has been \$.

Reconciled back to cash

Starting 1 July 2006 E*trade Total Account Value	\$
Ending 30 June 2007 E*trade Total Account Value	<u>\$</u>
Account Increase	\$
Withdrawals during the year added back	\$
Contributions during the year subtracted	<u>\$</u>
-	
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 Gains	\$
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 30 June 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 The income generated can be reinvested or withdrawn as per the client requirements.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

\$	-	<u>STABLE</u>	amount	yield	franking	\$cash	\$franking	\$total	gross%
						\$ -	\$ -	\$ -	
						\$ -	\$ -	\$ -	
		TOTAL	\$ -			\$ -	\$ -	\$ -	
\$	-	<u>QAULITY</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	\$ -			\$ -	\$ -	\$ -	

Because I don't want to sound like a broken record (or the boy who cried wolf once to many times) I'm not going to caution too much about the market situation - for anyone who keeps calling the contrary to what is currently happening will be eventually right as is a broken clock. Instead what counts is performance against what you set out to achieve. Against another strong general market (if we can call it a general market when the top ten stocks represent 45% of its value) we had another sound year, especially in light of our protected positions.

By observing the table below you will see your portfolio breakdown from the end of last year to the end of this year. The portfolio protection comes in the form of the percentage of the portfolio that sits in the store of value/income securities (see definition above) section. This acts like both an anchor and stabiliser in the portfolio. The prices of these securities don't move around as the market does, either higher or lower, but provide a steady return and a source of funds that will hold their value when much better stock buying opportunities present. Occasionally they can even surprise as the FCLGA securities have with their 20%+ return when even the 8% promised return was over the odds.

You probably noticed I don't provide percentage gains for the year (although privately I do use them) because they are only meaningful in the context of risk taken (if you think it essential take the yearly gain and divide by the start of the year total account value). I'll leave public discussion of the percentage gains to others who have a bad habit of measuring apples with oranges; instead I'll concentrate on absolute dollars; the kind you can spend.

Stocks commonly held that did well for us this year as compared to their closing price last year were: Flight Centre (FLT) \$9.93 to \$19.20, Telstra (TLSCA) \$2.00 to \$3.11, Babcock and Brown Capital (BCM) \$3.87 to \$5.50, ARB Corp (ARP) \$3.15 to \$4.30 and Harvey Norman (Go Harvey Go –HVN) \$3.94 to \$5.29.

Flight Centre as you would be aware is subject to an off again – on again offer from private equity and management. It would be easy to think that is the reason for the substantial rise in price, but it isn't the complete picture. During the past 12 months with Graham Turner back as CEO the company has increased earnings by somewhere between 25%-30%. This is the real story and why the private equity guys were interested in the first place. All the talk has been about the buyout but it looks like everyone has got the chicken and the egg back to front. If it wasn't for the profit potential those private equity guys wouldn't have been interested in the first place – Flight Centre is doing them a favour not the other way around.

Telstra or more precisely our Telstra instalment warrants (T3) shot the lights out. Because they are effectively a leveraged version of ordinary Telstra, until the second instalment is due, they move at a rate of about 1.6X more than the ordinary shares do. Sol and the Telstra team are fighting the hard fight – remember every time they cause commotions they are fighting for the benefit of us the shareholders, so I like it when the American hollers.

BCM is probably my favourite story for the year. Back at the beginning of 2006 I must have been called by three or four different brokers offering the stock at \$5 (two \$2.50 instalments). I never get offered IPO's, because we use a discount broker, so this one must have stunk for them to be calling me so much. Babcock and Brown set up this fund to find investments, similar to private equity. Subsequent to listing, the stock drifted to the \$3.70-\$3.80 range or a discount of about 30% to its holding assets, of which was mainly an Irish telecommunication company. That size discount was enough to make it a buy and in the same way I can't explain how the stock got so depressed I can't explain why the market changed its mind and started to buy it back to fair value at \$5.50 either. All that was in place before we bought is in place now except for the margin of safety. As they say in the thoroughbred racing game – you would like a stable full of them.

ARB, makers of four-wheel drive accessories, improved profitability sufficiently during the year but like so many stocks in the market the price earnings ratio uplift did the rest to the price. If you are curious about whom ARB are then every time you drive or walk past a vehicle with a bull bar look for the little red, white and black logo – I do.

If you remember from last year's report I mentioned both Harvey Norman and BHP both gained 60% over the year. Well this year in the same race we had a clear winner – HVN. HVN had a 34% gain while BHP gained 20% (finishing at \$35). So who really is the beneficiary of the awakening of China – you won't read that story on the front page of the Financial Review.

Like last year we had stocks that dragged their heels but were required holdings (both are now mentioned above) and so we have a couple today. Infomedia (IFM) has seen its earnings go sideways as the strong Aussie dollar has stalled earnings growth. But beneath the surface the growth of the underlying business has been strong. While the business continues to grow rapidly we will keep holding it, given an even break with the currency the share price has lots of up side. It is a similar story with STW Communication (SGN). The underlying business continues to grow soundly but the share price

dawdles. One has to give eventually and with the exit of Singleton and entry of Sorrel (UK mega advertising media baron) I'd say it would be sooner rather than later.

In summary many of our stocks have reached their fair level but are not expensive while we have a few that are still cheap. And this is the dilemma we face – how do we balance still remaining exposed to the bull market while protecting ourselves against the inevitable downturn. If we had pulled the pin on everything this time last year we wouldn't have had this year's gains so it is a question not easily answered. My best guess is the portfolio structure we have. If you have an improvement then do as Sol does and holler.

## **Market Observation**

*When a man with Money meets a man with Experience, the man with Experience gets the Money and the man with the Money gets Experience.*

Identifying exactly how our economy got itself into this current state of strong GDP growth, low unemployment, low inflation, low interest rates, strong profit growth, high asset value growth and everything else which is good is in itself an interesting task. When I'm looking at a company that is having fabulous results the question I ask is 'How long can this last?' Well there is only one way to answer that. And that is to think about why the results are occurring now – and then figure out the forces that could cause those results to stop occurring. And so it is with the Australian economy.

Here we can start and stop with China. In fact we get such a good deal out of China that Australia should introduce a national holiday called 'Thankyou China Day'. On two fronts China does us an enormous favour, firstly they are paying record prices for record volumes of minerals from our mining companies – but everyone knows that. Secondly they are supplying us with incredibly cheap imports of an improving quality thanks to their cheap and abundant labour force – but everyone knows that also. What is less known and understood and where the real boon is, is the exchange rate. With the Chinese Renminbi virtually fixed to the USD and with the USD depreciating against the Australian dollar, we are getting one massive free ride from China. Here we have a trading partner that is effectively paying more and more for the same volume of our exports while at the same time selling us their goods at cheaper and cheaper prices. It is almost too good to be true because in any normal trading relationship the ebbs and flows should balance themselves out – but not here because of the Chinese currency being fixed to the USD. When an economy gets more for doing less it explains most things that are good in that economy.

The implication to our economy is we have been earning greater export dollars for doing the same work which has been feeding through our financial system in the form of greater government revenue (hence tax cuts), greater profits (which are being reinvested by mining companies) and greater wages for anyone supporting that growth – from engineers all the way to lawyers and accountants. It is even feeding further as many businesses borrow or raise funds to develop opportunities to take advantage of the mineral boom.

On the other side of the coin we are effectively importing deflation. As our currency has rallied higher over the years the cost of importing goods has dropped. The lower prices are passed to consumers and inflation is tamed. It truly is the best of both worlds, kind of 'heads we win tails they lose'. This unusually beneficial combination is having another effect on our economy – booming asset prices. The combination of low interest rates and more disposable income results in assets being bid up to levels where once again people can't afford them. Effectively all the future income benefits are being capitalised today in asset prices. Of course this is all built on the assumption that these new higher incomes and lower costs of imports doesn't change.

And this brings us to the question of figuring out the forces that could cause those results to stop occurring. Well one thing that could spell disaster is a significant change in the Aussie/ Renminbi exchange rate, through a change in policy in either the USA or China. If our currency depreciates against the Chinese we will be importing inflation by spending more Aussie currency for the same amounts of imported goods while receiving lower Chinese currency for the same export work and all that was going for us would start to work against us. I don't know if it is enough to stop the party but it would give it a shake up and an impact would be felt on the ASX.

One thought I want to leave you with has to do with financial engineers and structural engineers. When I finished Uni in 1989 it was boom times (just like now) and jobs were a plenty. One that I came across was for a financial engineer at Citi Bank. At the time I wasn't sure what they did but it sounded like it had something to do with engineering – or so I thought. Fast-forward to 2007 and I think we have all heard of financial engineers. It turns out they are the ones the investment bankers rely on for the complicated maths, putting together all these takeovers and deals using excel spreadsheets and projections into the future based on current operating conditions that result in precise valuations to justify takeover activity and investment.

Anyway, I got to thinking what would happen if we swapped the roles of these two engineering professions. Let the financial engineers build bridges and structural engineers make or justify investment selections.

Now the structural engineers are taught to build everything with a margin of safety such that an excess unforeseen event or weight in the case of a bridge doesn't see it collapsing. So I'm pretty confident of the quality of the investment decision this group would make given their ingrained conservatism.

What about the financial engineers building our bridges – how long would it be before the first one collapsed because it was only to withstand the time necessary for the banking fees cheque to clear. Chances are we would stop using bridges pretty quickly but at least our investment portfolios would hold up against a bit of extra weight. Just a thought.

Finally, it wouldn't be one of my reports if I didn't mention Warren Buffett, so here goes.

Like Buffett I am seeking an investment apprentice. Let me explain. I am interested in hearing of any child who upon being given some cash to spend at a shopping centre returns later with the money intact saying they couldn't find any bargains and want to come back when the sales are on. Let me know who they are and I will give them a job when they have finished Uni. I'll wait. As for the spendthrift they have a bright future in investment banking because they never say no to spending other peoples money – sale or no sale.

Kind regards

**Justin O'Kane**  
**Portfolio Manager**