

19 July 2010

Dear client

Welcome to the 2010 end of financial year report.

The financial year ending 30th June 2010 has proven to be a beneficial year resulting in our strongest returns since this service started operating seven years ago, both absolute and relative to benchmarks.

A portfolio invested 100% according to the SP200 weighting (the market) would have gained approximately 13.7% for the financial year after including dividends and franking credits. Established accounts stringently invested according to my recommendations (representing over 80% of all clients), as defined by Essential, Balanced or Absolute accounts, either nearly doubled this return or did better than double. The newest type of account, where an existing portfolio is transferred across to the service and is progressively rebalanced to reflect an established portfolio, also performed well against the market and their objectives.

This letter contains the results for your portfolio for the financial year reconciled on a cash basis. The accrual reporting process where results are expressed in the accounting terms of realised and unrealised gains/losses will no longer be co-reported. This is due to the difficult nature of maintaining the exact unrealised figures on E*Trade plus what has proven to be restricted client usefulness in interpreting these financials. For any client interested in the unrealised profit and loss figures, please refer directly to E*Trade's website, but bear in mind some alterations may be needed.

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).

Cash reconciliation

Closing E*Trade account balance on 30 June 2010	\$ -
less	
Opening E*Trade account balance on 1 July 2009	\$ -
	<hr/>
Change in the account balance	\$ -
<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	<hr/> <hr/> <u>\$ -</u>

% change from the opening balance for the period

* contributions/withdrawals explained

less contributions of cash into E*Trade ANZ CMT (incl any direct debit div) \$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

Notes

- The E*Trade account balance (made up of securities and cash) for the 1 July 2009 can be found in either of the last two letters - presented as the closing balance 30 June 2009 for FY 2008/09.
- Full franking credits are used as the majority of accounts are superfunds for which an ATO credit is due.
- This is not a tax accounting report.
- If not previously advised, should a client want me to match buy and sell transactions for tax preparation purposes, please let me know.
- This report is pre fees but includes brokerage.

(Please remember that not all client portfolios are the same. They can differ on what securities are held and by what percentage. The reason for the different individual situations comes down to the time the client joined the service through to the investment balance needed from their portfolios. As a consequence not everyone may hold the security in question or have the same asset weightings, so some individual stock discussion may be less consequential for some as it may be to others. As a rule unless the stock was held by at least half the accounts it is not mentioned.)

Our Objective

Equities

“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

In the last letter to clients, I introduced our investment objective for the equity component of our portfolios. For us to perform well, our selected stocks as a group need to meet this objective. Having businesses we own earn more over time is our best chance to generate absolute gains and beat the market.

It is my job to identify these businesses, understand them, and monitor their progress to ensure what is anticipated does or can still eventuate. My job is done well when new businesses are identified and added at attractive prices; existing businesses are either added to or reduced as their prices move well below and above their value; and when the anticipated future economics of businesses owned materialise.

While that may seem simple enough, someone else knowing or sharing our client stock list is far from guaranteed the same results we enjoy if they don't achieve the same prices we buy and sell for. An All Australian footy team virtually picks itself, but try getting them all into your dream team simultaneously and it is impossible. In the case of equities, we generally know who the All Stars are, but to acquire a dream team full of them we have to take full advantage of our freedom to be selective about when we add them. Take for example this list of A graders and observe their recent high to low price history: Macquarie Bank \$97.45 to \$15, Harvey Norman \$7.25 to \$1.91, Flight Centre \$32.48 to \$3.39, Platinum Asset Management \$8.08 to \$2.73 and Billabong \$18.81 to \$6.23. Anybody adding these All Stars at unattractive prices won't be getting much of a return on their money.

The other part of my job which you don't see; is the stocks that are considered but not recommended. Normally it takes three to five weeks to analyse a stock of interest, but unfortunately it can take the same time to analyse a stock that does not become of interest. At OKIS we share John West's vision – “it's the fish John West reject that make John West the best”; and so it is with stocks.

This helps explain why our portfolio turnover is so conservative but it also means we can end up mistaken for a duck; calmly swimming on the surface but paddling like hell underneath.

So how did the earnings of our basket of stocks perform this year?

Stock Code	30-Jun-09 price	2008/09 EPS	30-Jun-10 price	2009/10 EPS*	Stock price Change	EPS Change
					3%	10%
					0%	11%
					42%	17%
					-7%	0%
					61%	31%
					-5%	3%
					90%	35%
					14%	17%
					52%	-2%
					29%	17%
					0%	-4%
					24%	14%
					5%	18%
					7%	9%
				Average	22%	13%

While the list of 14 stocks does not capture all account stock holdings, it does represent those stocks most common across all portfolios – especially stocks defined as quality. The averaged increase in earnings per share across this portfolio was 13%, comfortably meeting our goal (*for those businesses with 30 June cut off's market estimates are used). In some ways this was not a difficult task given a 2008/09 low earnings watermark, but don't be too dismissive because eight of the 14 businesses either had their best or second best profit year on record. I'm looking forward to what can be done without the shackles of GFC.

Free Loading Preferred

The first two businesses I want to point out are ARB Corporation (4WD accessories, ASX code ARP) and Flight Centre (ASX code FLT). Any business we own needs to possess a competitive advantage – meaning, more customers buy from our company compared to its competitor, for the reason that they sell their goods and services for cheaper prices/more choices, or alternatively their product/service is superior (rarely is it both) while maintaining strong profit margins. Owning businesses with such characteristics doesn't guarantee success but it sure helps, and in 2009/10 it paid off in an unexpected way for these two. With both the automotive and airline industries facing continued difficulties, the major industry participants (airline carriers and car manufacturers) did the only thing they could and sacrificed their own profits by cutting prices aggressively making it very attractive for the buyer. For example, tickets to Los Angeles dropped to less than \$1,000 from \$2,000. Sure enough, as is taught in economics, if you lower the price of anything enough you will increase demand; so consumers bought new vehicles and flew again. Our two businesses' profits prospered as demand was lifted yet our businesses paid no price to the cost of the stimulus. ARB Corp remained the 4WD accessory supplier of choice to all those extra vehicles sold, while Flight Centre became more important to the airline carriers as they desperately competed against each other to move the mountain of discounted tickets – so much for the internet threat! (Even Singapore Airlines rejoined the fold.)

Free loading is usually frowned upon in society, but in business it is an advantageous quality making for a desirable investment. There were other helping factors in the form of government tax breaks and a high Australian dollar - but only exceptional businesses can enter a GFC and come out the other end better off.

Death of a Salesman

A quick glance down the list of stocks shown previously will highlight one glaring anomaly: office supplier Corporate Express (ASX code CXP). Bearing a 52% price gain against a 2% profit drop, thanks to a takeover from major shareholder Staples, Corporate Express this year leaves the fold. On face value we should be pleased with the 'easy' gain made available from the takeover but that may well be offset against the loss we will suffer from having the stock 'taken' from us below what it could generate our portfolios in years to come. Consider: 1) that Staples is a more informed buyer than those who represented our selling interest; 2) the last five or so years of investment made by Corporate Express to reduce costs, for which we paid the price and were yet to receive the benefits, will go to Staples; and 3) the generally low level of market confidence deflating takeover premiums; and it is possible to imagine we just might have been stiffed on this deal, despite the price/earnings anomaly of 2009/10.

While the above concerns temper the joy of the takeover 'bonus', it is another loss unseen for which we will pay for a long time to come. Quality businesses like Corporate Express are rare, because only a few businesses are capable of taking stranglehold position in their industry, that result in exceptional returns on capital and near certain futures in earnings. Our continued loss will come in the form of having lost a 'go to' stock when future markets tumble. I am referring to unknown future dramatic market falls like this recent one, where general confidence is lost yet there are certain stocks we could 'go to' with confidence and buy cheaply despite the uncertainty. Many smart investors have been employing this tactic for decades, so it suits us that this sort of company be publicly traded. Considered from this perspective, this corporate loss represents a much larger opportunity cost down the track.

New Kids on the Block

Two new businesses were added to the quality list of stocks this financial year: hospital operator Ramsay Health Care (ASX code RHC), and funeral home operator Invocare (ASX code IVC).

Ramsay is the largest private hospital operator in Australia. Any hospital is most profitable when it: 1) does surgical procedures rather than medical procedures; 2) has shorter patient stays rather than longer stays; 3) has complex cases and not simple cases; and 4) has no hospital next door doing the same. In the past Ramsay has acquired hospitals, then re-jigged the mix of the hospitals' offerings to maximise this combination, resulting in any capital expenditure not only becoming profitable but also more relevant to the insurers - thus leaving other under-developed hospitals behind. In a way, Ramsay is like Westfield - always trying to get the right mix of tenants to max rental yields. With Ramsay's existing dominant hospitals, they have continued adding beds/wings/surgeries etc., which has proven high margin investments. This is important because the more capable the hospital, the better the quality of the doctor/surgeon/specialist who is attracted - who in turn brings in more patients.

If the hospital is hugely relevant to the community, then the insurer must have it on their books so they can attract insurance customers. A number of years ago there was a nasty health insurance hospital rebate war between Healthscope and BUPA, who fought over Adelaide and Darwin hospitals, which showed just how important this balance of power is. Any hospital not at the high surgical procedure end, with longer rather than shorter patient stays and doing less complex cases, is at the unprofitable end and the insurers pick them off. Insurers can't do that to Ramsay. This industry truly looks a winner take all scenario.

Once someone has a dominant hospital position, you want them to be spending as much cap ex as possible – it is all profitable. Ramsay in Australia is currently spending \$500 million on expansion. And, unlike pathology and radiology that are subject to claw back from the government (almost every year), I don't think the government can or wants to do a thing about this. The last serious change in private health insurance numbers wasn't due to the 30% rebate (the carrot), but instead the life time health cover initiative (the stick), i.e. if you don't have health insurance by the age of 30 you pay the extra %. This costs the government nothing but pushes and retains many to private health insurance which is what the government needs.

Ramsay has moved into the UK which has been profitable. However, it is their more recent move into the fragmented French hospital industry, where the private health insurance take-up rate dwarfs Australia, that looks very appealing. Ramsay fits the bill of a company whose earnings are virtually certain to be materially higher years from now and the price we paid was rational.

The other business to join our ranks was Invocare. Unlike Ramsay Healthcare, who concentrate on minimising costs (it has a 4% profit margin), Invocare instead focuses on points of differentiation; i.e. becoming the funeral home of first choice. Funeral homes under Invocare's banner include Le Pine (local), White Lady (national) and Simplicity (national); but they have equally well established operations in other states. Some of these businesses have been operating for over 100 years. Invocare presides over 22% of funerals nationally and 33% in the markets in which it operates; i.e. one in three funerals. In NSW and Queensland they also operate cemeteries/memorial parks and crematoriums, performing over 70% of cremations in NSW and over 40% in Queensland.

No one likes talking about the business of death, and it isn't the market size that makes Invocare appealing, so I'm going to stop talking directly about Invocare. Instead I am going to tell you about a Los Angeles chocolate confectioner, See's Candy; because it is through their story you will see the economic appeal in Invocare.

You may be aware in May I went back to Omaha again! I have now been to see Warren Buffett and Charlie Munger more times (three) in the last five years than I have seen Richmond win games of football live (two). At this year's meeting Buffett mentioned only one business multiple times and that was See's Candy. The following is an edited extract from a talk he gave in 1998 about the virtues of See's.

*"We never hired a consultant in our lives; our idea of consulting was to go out and buy a box of candy and eat it. What we did know was that they had share of mind in California. There was something special. Every person in Ca. has something in mind about See's Candy and overwhelmingly it was favorable. They had taken a box on Valentine's Day to some girl and she had kissed him. If she slapped him, we would have no business. As long as she kisses him, that is what we want in their minds. See's Candy means getting kissed. **If we can get that in the minds of people, we can raise prices. I bought it in 1972, and every year I have raised prices on Dec. 26th**, the day after Christmas, because we sell a lot on Christmas.*

It is a good business. Think about it a little. Most people do not buy boxed chocolate to consume themselves, they buy them as gifts— somebody's birthday or more likely it is a holiday. Valentine's Day is the single biggest day of the year. Christmas is the biggest season by far. Women buy for Christmas and they plan ahead and buy over a two or three week period. Men buy on Valentine's Day. They are driving home; we run ads on the radio. Guilt, guilt, guilt—guys are veering off the highway right and left. They won't dare go home without a box of Chocolates by the time we get through with them on our radio ads. So that Valentine's Day is the biggest day. Can you imagine going home on Valentine's Day—our See's Candy is now \$11 a pound thanks to my brilliance. And let's say there is candy available at \$6 a pound. Do you really want to walk in on Valentine's Day and hand—she has all these positive images of See's Candy over the years—and say, "Honey, this year I took the low bid." And hand her a box of candy. It just isn't going to work. So in a sense, there is untapped pricing power—it is not price dependent.

The last word on Invocare is that they hold a degree of pricing power like See's Candy and like See's, their activity isn't price dependant – what works in candy works in funerals. Few businesses in Australia have the ability to raise prices consistently and maintain a constant 88% satisfaction approval; Invocare is one of them. Forget the favourable demographics (or unfavourable depending on how you look at it) with that kind of advantage the rest of the financials has a good chance of looking after themselves.

We now have investments in our portfolio spanning from the cradle to the grave and doing a lot in between. Try going a week without shopping at Woolworths or a Westfield or seeing an advertisement for Harvey Norman or Flight Centre or walking past someone wearing Billabong or driving past a 4WD utility sporting ARB accessories or reading a bank statement from a Macquarie CMT just to name a few. I bet you didn't know that it was STW Communications who ran the successful advertising campaign against the mining super tax.

Asset Allocation and Flexibility

This year marks the seventh anniversary of OKIS operating an Investor Directed Service for clients. In that time we have seen a full investment cycle starting from the lows of 2003 through to the highs of 2007 and back to the lows of 2009. What excites me a great deal, is more than half the current client base is made up of clients who have been with me for the entire journey, while many more have been four and five year clients (and still counting). I truly have a great client base.

The reason I reflect is that I had cause to review the last seven years of results for all client types; Essential (targeting 50% stocks/50% cash-income securities), Balanced (targeting 70% stocks/30% cash-income securities) and Absolute (targeting 100% Stocks). What became apparent was not only the benefit of having part of the portfolios protected from the vagaries of market swings in the form of cash/income securities, but the important benefit of what is derived from having the flexibility to hold higher percentages of cash-income securities when stocks looked expensive and vice versa, when stocks looked obviously cheap.

It is not a coincidence our portfolio percentages in stocks were at their lowest percentages when the market was at its highest and the opposite when the market was on the lows. This is counter intuitive because the simple maths suggests it would normally be the other way around. It is this flexibility to adjust above and below our ratio of stocks/income securities-cash that has enabled us to outperform the market handsomely over the last two years.

Being able to enter the market and wait to transact at the price of our choosing without any obligation back to the market effectively provides us with a free option. I don't know what a lifetime of free options of this nature is worth, but I do know this arrangement is valuable if used wisely. This is where asset allocation and flexibility become important because it is through maintaining some form of 'available' funds that we can exercise our free option when appropriate.

The Market

At the risk of sounding like a financial pundit able to seamlessly explain what happened yesterday and what will happen tomorrow, I wish to share the following insight. Recently I examined the past 110 years of the Dow Jones and past 200 years of the English stock market to see if there was any year by year volatility in market returns subsequent to a serious market correction. A serious market correction being something like a 25%+ drop either in one year or accumulated uninterrupted consecutive years. To put it into today's context, after the 41.1% drop of 2008-2009 and then 2010 8.9% rally, was there any history supporting a dramatic market fall in the next direct year, i.e. 2011. My belief was that after a market route, followed by a worthwhile market bounce, even if the economy was slow to recover, those sellers wanting out were already out of the market thanks to the fear during the large route. Thus leaving a sturdier and more resilient shareholder less inclined to sell out on any further delayed economic recovery.

I didn't find any previous pattern suggesting a significant fall directly following the rally, so despite any current pessimism, 2011 may actually turn out OK. Before anyone gets too excited, be assured despite being armed with such a 'powerful' observation, I will continue to be guided first and foremost by the 'Frankie Rule' (Frankie being the family dog). That is, before I mow the lawn at home, despite the assurance a scan for dog droppings brings, I still mow with the trepidation of what I've missed!

Top 40

I have a request to make but first a useful story about a dentist.

Dentists have the highest suicide rate of any profession. Considering that no one is ever pleased to see a dentist, that they usually have to inflict pain on their clients and that clients normally leave a surgery in some discomfort; is it any wonder they feel under-appreciated. Consequently, many dentists leave the profession, while for others it has led to suicide. According to a story I heard, one such dentist in New York thought he was at the crossroads before he came up with an inspired plan.

After a time of reflection, this dentist wrote to all of his clients. To 80% of them he wrote that his surgery would no longer be able to accommodate their needs and so referred them to an alternative dentist. To the other 20% of his customers, whom he personally liked, he wrote that he would be continuing to service their needs but that the surgery was no longer open to the general public, only them – he also doubled his fee (don't get nervous – that's not where I'm going). The final thing the dentist did was to include in the letter he sent to the 20% of clients he liked three little red apples. He requested that these preferred clients pass the red apples to three people they most liked on the basis that if he liked dealing with the chosen clients he would probably also like dealing with their friends, i.e. likeminded people. Only if their friends and associates had a red apple would they be able to get an appointment.

With only the preferred clients and their likeminded friends now attending the surgery, it became a place people actually wanted to attend. Combined with other cosmetic changes made (edited to keep the story short) importantly the dental experience improved for all. The dentist had taken a big risk making the changes but word got out and before long, queues formed outside the surgery door asking those leaving if they had a spare red apple – after all it was the only way to get in. Now for my sales pitch.

As mentioned, OKIS has successfully completed its seventh year of serving clients and currently has approximately 26 clients with double the funds from the 2007 high! Once the client number hits 40 this door is closing also – so it is open to the next 14 only. This number ensures I will always be able to attend to individual client needs including all communication and ensure we can buy and sell any security with minimal market impact – thus maximising returns. The aim of OKIS was never to be the biggest or turn me into one of the richest but instead to be one of the best at what it does – investing wisely for client needs.

There is nowhere else in Melbourne you can have a Certified Financial Analyst Institute charter holder with over 20 years real market experience act directly on your financial behalf like at OKIS. In a world where many financial advisors ignore their fiduciary duty OKIS prides itself on making that responsibility the cornerstone of every decision we make.

If you have found three cards with OKIS.COM.AU and my name printed within this packet then I would like you to pass them onto someone whom you trust financially. My suggestion would be the person you appointed as the executor of your will, a power of attorney you may have appointed in the event of something happening, a business associate you like or someone else for whom you share a personal financial relationship with – it could even be a golf buddy. These people will listen to you and I will be happy to listen to them. OKIS will even establish a Self Managed Super Fund with Australia's leading superannuation accounting specialists without charge for the first 14 new clients if appropriate to do so. I look forward to your help.

Please let me know if anything in this letter or that occurred during the year needs clarifying. My next letter will be early January 2011, summarising the first half of the year.

Yours sincerely

Justin J O'Kane, Certified Financial Analyst