O'Kane Investment Services Pty Ltd
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20 July 2011

Mr & Mrs Client

Dear

Welcome to the 2010/11 financial year report covering client portfolio performance and analysis.

In this financial year, being the period 1st July 2010 through 30th June 2011, the S&P 200 (the market) opened at 4301 and closed at 4608, for a gain of 7.1%. Add market dividends and franking credits (approximately 5.2%) and a benchmark portfolio 100% invested in only stocks would have returned approximately 12.3%, a benchmark portfolio invested 70% stocks and 30% cash deposits - a gain of 9.9%, and a benchmark portfolio invested 50%/50% - a gain of 8.4%. While the first half performance of the 2010/11 financial year was strong for client portfolios the second half was not. Despite the uneven yearly performance client accounts having been in operation for 12 months or longer and invested according to my recommendations, still achieved results around their risk adjusted benchmarks for the full year.

For clients with an eagle eye for detail you will notice I don't refer to the accumulation index when measuring market returns and portfolio performance. The reason for this is the accumulation index assumes dividends are reinvested as they fall due. The impact being the accumulation index overstates losses as markets fall and overstates gains as markets rally off lows as compared to a portfolio in which the dividend is retained by the client. Should more clients wish to have their dividends directly credited to the ANZ E*Trade account please let me know.

Finally this letter contains the results for your portfolio(s) for the 2010/11 financial year reconciled on a cash basis. Also contained are printouts 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 your risk objective review and a position summary report (consolidated for multi account clients) with future dividend estimates.

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Results for the Financial Year of 2010/11

Cash reconciliation

Closing E*Trade account balance on 30 June 2011	**$**	**-**
less		
Opening E*Trade account balance on 1 July 2010	$	-
Change in the account balance	$	-
less		
Contributions made in the period*	$	-
add		
Withdrawls made during the period*	$	-
add		
dividends and franking credits earned during the period	$	-
(excludes dividend reinvestment)		
TOTAL net GAIN/LOSS for the period	**$**	**-**

% change from the opening balance for the period

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

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

Markets & Portfolio Reviewed

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What has shaped the 2010/11 financial year?

The Greek debt crisis, European debt contagion threat, Middle East democracy unrest, American jobs problem, American budget deficit problem, Chinese inflation threat, the threat to world growth, a high Australian dollar, Kevin Rudd's political assassination, Queensland flood disaster, N.Z. earthquake disaster, Japanese tsunami and nuclear radiation disaster, NBN rollout (disaster?), Federal Government $50 billion budget deficit blowouts, rising interest rate, Australian housing bubble, online retail threat, the $1,000 GST importation exemption threat, the mining tax, the carbon tax, not to mention the boat people, wikileaks and the assassination of Osama bin Ladin are all events amongst others which shaped the 2010/11 financial year. Why did the market move the way it did in 2010/11? Take your pick from the above but it is 7% higher from the start of the year, not exactly the kind of result to have been anticipated should the events have been known in advance. Twelve months from now another list of problems and threats will be there but those aren't guaranteed to shape our investment returns in a way we would anticipate either.

The uncertainty of economic and political outcomes doesn't mean investors mimic an ostrich and stick their head in the sand (or in 21st century terms – just turn the volume up on our iPod) and ignore dangers but instead position themselves ahead of time for possible outcomes. The equity components of our client accounts have meaningful weightings towards export companies with large components of non-Australian dollar revenue and earnings.

Should Chinese demand for commodities moderate and impact commodity pricing i.e. iron ore, coal etc our dollar is susceptible to a reasonable pull back which will coincide with a weakening in unemployment, budget deficit blow out, inflation and likely rising interest rates against the normal trend. This could extend to a weaker housing market further exacerbating the situation. Consequently businesses capable of earning off shore earnings would repatriate more Australian dollars than today helping with their valuations and share prices.

This of course works the other way on the strengthening of the Australian dollar but then again these businesses are growing in America, Europe and Asia offsetting the dollar rise. These companies were good enough to compete beyond Australia because the goods and services they offer are focused on meeting customer needs better than their competition. We only follow the best companies overseas not the hopeful and wishful.

There is also exposure to integrated retailers (integrated into wholesale, manufacturing and property ownership) for whom some are suffering and there is conjecture as to the cause of this concern. Is it online retailing trends or rediscovered saving habits of consumers on the eastern seaboard? A detailed look at Harvey Norman later may assist.

Finally, a small but growing list of businesses added in the last 18 months that operate pretty much independent of any of the factors mentioned above have made their way into the portfolios at decent prices. This trend is expected to continue.

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Investing wasn't meant to be easy

Malcolm Fraser is credited in parliament with saying 'Life wasn't meant to be easy'. Malcolm Fraser could have been talking about investing. Take for example this Macquarie Group case which showcases the conflicts between investing for the short term and the long term as evidence of the difficulty of sound investing.

Macquarie Group has six business units that contribute to the Group's total earnings. Three of those business operations generate earnings that are relatively stable and provide annuity like earnings. The other three units have more volatile earnings which are leveraged to yearly market activity. In the chart below you can see the business units grouped according to their earnings profiles. Also from the chart you can see five year earnings averages, lows and highs which provide an idea of the variance involved, as well as 2010 and 2011 earnings.

Historic earnings (NPAT in millions)

Business segment NPAT*	FY10	FY11	5 yr avge	5 yr low	5 yr high
Macquarie Funds	813	602	700	300	1,100
Corporate & Asset Finance	255	501	200	100	500
Banking & Fin. Services#	113	233	200	200	300
Annuity style earnings	1,181	1,336	1,100		
Macquarie Securities	580	175	600	200	1,200
Macquarie Capital	-56	281	700	-100	1,600
FICC	827	575	600	500	800
Market linked earnings	1,351	1,031	1,900		
*Before corporate costs					
#Incl. Real Estate Banking					
Source: MQG/Morningstar					

Annuity style earnings, while not without some individual business variance are progressing upward providing a foundation for future growth. Meanwhile the market linked earnings reflect the weak market activity volume levels we are currently experiencing. No one sees a near term catalyst for those volumes and earnings to rebound, but neither do many deny market activity levels will ultimately recover. For example, take this June 2011 comment from an equity analyst at an investment bank as he wilts and downgrades his recommendation against his own view:

"Whilst we remain confident that Macquarie will deliver long run return on equity of around 15 to 20 per cent, leaving Macquarie looking cheap from a fundamental view, the near term outlook is not so bright."

"Weak market conditions, continued speculation about the strength of the franchise conditions, and the potential for a Standard & Poor's bank ratings review will likely impede the near term earnings and share that price".

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Current market attitudes are the opposite to the lead up to the GFC in which everyone knows there is impending danger but keep buying anyway for fear of missing a rising price. Now everyone sells in fear of a falling price. Meanwhile Macquarie Group in anticipation of an eventual recovery are expanding their reach during depressed times.

The net effect of the current earnings from the combined business units is that Macquarie Group currently earns approximately 8.4% return on their equity – shareholder equity being the difference between company assets and liabilities, currently worth $32.88 per share. The current return is below the 20% return earned during the unusual period of market activity building up to 2007 but well below the more modest long term return of 14%-15% expected by most analysts going forward. Regaining a 14% return on equity will see earnings per share grow from $2.76 to $4.60 (earnings peaked at over $6 per share in 2007/8) and dividends grow from $1.86 to $3.10 per share. It can't be underestimated the changed circumstances that need occur for this to happen but it does make Macquarie Group the equivalent of a V6 car operating on three cylinders and everyone knows it.

As owners of Macquarie Group we are not looking for $10 upside or downside in the stock price through time, but closer to $40 upside. To catch such a gain, investing shouldn't be easy. We need to concentrate on if it will happen, not when it will happen, because the rewards are there for taking on a difficult task.

In the money management business, the requirements for a successful business are gaining the trust of those you serve, and secondly, deserving that trust through your actions.

The inherent difficulty for many clients in judging recommendations is that generally clients can only observe the recent share price changes as a measure of success or failure. The purpose of these client letters is not just to relay important end of financial year information but to exhibit that the trust placed is deserved through detailing the level of knowledge and process behind the advice. Below we look at Harvey Norman as an example of this.

Harvey Norman – detailing our investment rationale

Pick up an annual report and you will most likely read Gerry Harvey describe Harvey Norman as an "integrated retail, franchise and property system". This may seem like corporate speak but it captures the reality of the situation, and, if anything, may undersell the importance of the combination of activities on its success.

The Australian franchise business co-exists with the property businesses

Harvey Norman provides advertising and administration services to 370 plus franchisees who sell $5.2 billion worth of goods and services annually from 194 stores, profiting on average between five and six cents from every dollar of franchisee sales. Harvey Norman also owns and collects rent on 73 of these properties tenanted by franchisees and third parties. The integrated franchise and property system is important because it enables Harvey Norman to assist franchisees during competitive and difficult retail operating environments by effectively subsidizing and keeping them soundly in business. This lowers Harvey Norman's returns in the short term but enables the franchisees to remain ultra-competitive winning customers during depressed times and building all important market share. When better times return, Harvey Norman resumes taking a larger cut of a then larger sales volume resulting in higher earnings. Add new store openings or the purchase of fallen competitors (Megamart, Retravision NSW, Clive Peeters) and sales are even higher.

Further, Harvey Norman does not sell the franchises, but gives them to people. This ensures they get the store operator they want who takes financial responsibility for the store operation. Should an operator fall short in controlling costs or in gaining sales, then Harvey Norman is capable of replacing the franchisee with someone else that has probably worked their way through the system and shown promise. This system results in ambitious sales people working for the benefit of Harvey Norman as well as themselves.

Harvey Norman, through its economies of scale in distribution, purchasing, marketing, sales force and with the leverage from the property integration, is separated from just about every other retailer in Australia who doesn't share this competitive advantage. The proof is in the results and fallen competitors.

The degree to which Harvey Norman's franchise margin swings can be seen from the table below, especially on the half yearly basis. With a peak of 6.7% (economic top and government stimulus) and a low of 3.2% (petrol at $1.70) the competitive and varied nature of retail can be observed. These variations are just part of the Harvey Norman business as it continues to outcompete.

	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001
Franchisee Sales (million)	$ 5,190	$ 5,060	$4,860	$ 4,500	$ 3,960	$ 3,530	$ 3,240	$ 2,900	$ 2,610	$2,390
Growth from last year	2.6%	4.1%	8.0%	13.6%	12.2%	9.0%	11.7%	11.1%	9.2%	
Store numbers	194	195	194	192	174	163	160	155	147	
HVN profit before tax (million)	$ 310	$ 300	$ 286	$ 243	$ 169	$ 167	$ 171	$ 151	$ 134	115
First half year franchisee margin	6.7%	5.8%	6.7%	5.6%	5.3%	5.6%	5.5%			
Second half franchisee margin	5.3%	6.4%	5.2%	5.2%	3.2%	3.8%	5.1%			
Full year franchisee margin	6.0%	5.9%	5.9%	5.4%	4.3%	4.7%	5.3%	5.2%	5.1%	4.8%

What is important though in judging Harvey Norman's value as an investment, is to understand its earning power, being the base annualised franchise margin that is dependable through time.

The property businesses

The property leg of Harvey Norman owns, buys, and develops land and buildings into retail stores and then rents them out to franchisees and third parties in Australia (73), New Zealand (16) and Slovenia (3). Globally the property portfolio is worth approximately $1.90 per share. The property activity is funded from company profits that are not returned to shareholders as dividends.

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	2010	2009	2008	2007	2006	2005	2004	2003
Number of properties								
Australia	73	73	72	69	66	63	63	61
New Zealand	16	16	15	14	13	13	12	10
Slovenia	3	2	2	2	1	1	1	1
Value of properties (million)								
Australia	$ 1,393	$ 1,317	$1,179	$ 1,020	$ 892			
Under construction	$ 95	$ 80	$ 134	$ 79	$ 51			
Joint venture	$ 140	$ 189	$ 187	$ 106	$ 96			
NZ, Singapore, Slov	$ 231	$ 214	$ 183	$ 207	$ 183			
other	$ 18	$ 20			$ 32			
Total	$ 1,877	$ 1,820	$1,683	$ 1,412	$ 1,254			
Accumilated revaluation	$ 440	$ 470	$ 475	$ 410	$ 341			

While the importance of the owned property in gaining Harvey Norman an advantage when competitors are faced with fixed rents has already been acknowledged, it should also be noted the growing significance of the rental stream from the owned properties. For example, earnings before interest and tax on Australian rented properties are now worth $107 million per annum, up from $73 million in 2006 when 66 properties. With more operating stores than owned premises, Harvey Norman has a long list of readymade reliable tenants for whom properties can be developed – further enhancing the competitive advantage over traditional retailers and creating additional income streams at the same time.

<u>Traditional company owned retail operations</u>

Finally, Harvey Norman has company owned traditional retail operations overseas in places like New Zealand, Singapore, Slovenia and Ireland. This is the weakest part of Harvey Norman's business as evidenced by the problems in Ireland. The international businesses, bar maybe the New Zealand operation (which owns property), do not enjoy the competitive advantage the Australian business does. This may change through time but in the interim it does not consume much in the way of net operating assets either, making this a marginal component of Harvey Norman. Gerry Harvey has a history of trying many different ideas of which some work, for example the purchase and sale of sports good operator Rebel, while others fail, like the move into office supplies. Exploring opportunities has always been an important ingredient to Harvey Norman's long term success.

Profit before tax (million)	2010	2009	2008	2007	2006	2005	2004	2003	2002
New Zealand	$ 48.4	$ 44.4	$ 52.7	$ 47.6	$ 44.5	$ 35.0	$ 25.0	$ 21.0	$ 12.8
Asia	$ 10.4	$ 8.4	$ 10.0	$ 11.8	$ 10.8	$ 10.0	$ 8.8	$ 7.7	$ 1.1
Slovenia	$ 3.3	$ 3.1	$ 2.4	$ 0.5	$ 0.6	-$ 0.6	$ 1.2		
Ireland	-$ 50.4	-$ 76.6	-$ 9.5	$ 1.4	-$ 5.3	$ -	-$ 0.2		
Other	$ 7.0	-$ 11.4	$ 4.0	-$ 1.1	$ 3.2	-$ 5.8	-$ 6.0	-$ 3.2	-$ 3.0
Total	$ 18.7	-$ 32.1	$ 59.6	$ 60.2	$ 53.8	$ 38.6	$ 28.8	$ 25.5	$ 10.9
Net assets employed	$ 145	$ 118	$ 104	$ 117	$ 74	$ 72			

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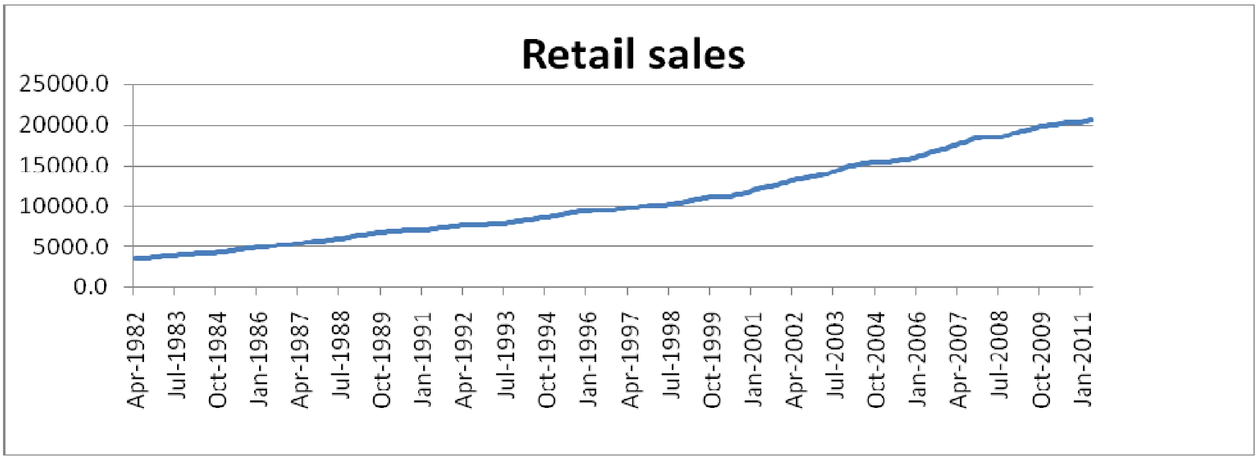
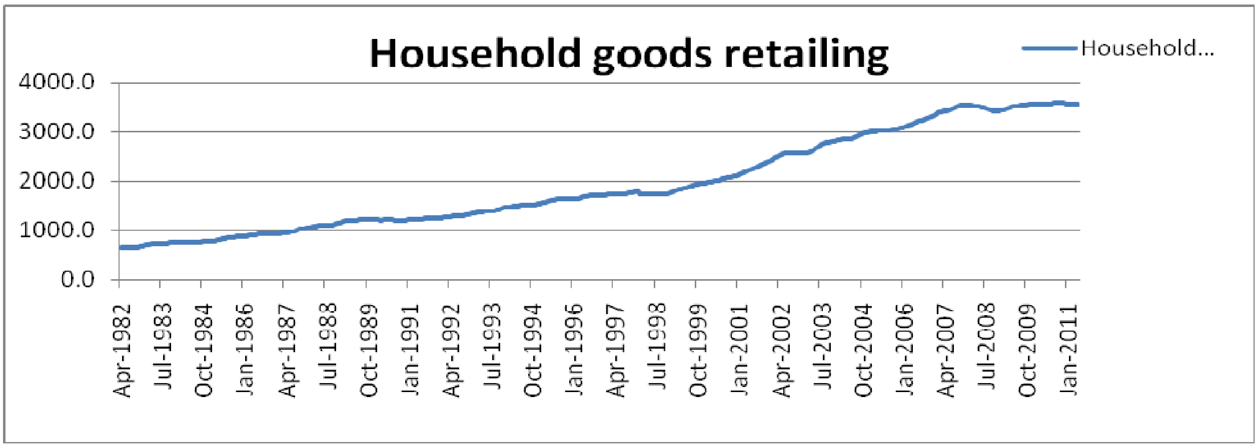
So far we have detailed how Harvey Norman operates and how the property operation uniquely compliments the franchise business to make a formidable retail competitor capable of outperforming during strong retail environments and gaining relative strength during poor retail environments. Next we will look at the current retail situation, including Harvey Norman's situation, and the emergence of online retailing as a threat to Harvey Norman.

Retail Sales and Household Goods retailing

Total retail sales include all food, household goods and services, personal items and department stores, and amount to about $20 billion monthly. Growth in total retail spending can be observed below for the last 30 years on a monthly basis. The steady growth in monthly spending at just above 6% per annum reflects growth and inflation in the economy. I'm pretty sure in 5, 10 and 20 years from now that blue line will trend higher.



Harvey Norman competes in the retail sales subcategory of 'household goods and services' which has sales of approximately $3.5 billion monthly or $43 billion annually. Harvey Norman's annual franchisee sales contribute 12% of all those sales up from 9% a decade ago, meaning Harvey Norman is either winning market share, and/or its categories are becoming more relevant to consumers. In the chart below you can observe the 30 year growth in household goods and services retailing on a monthly basis. Just as with total retail sales I expect this category to grow through time as more households are created, population expands, inflation impacts and the economy grows. Fiscal and monetary economic policy may impact the speed but not stop it.



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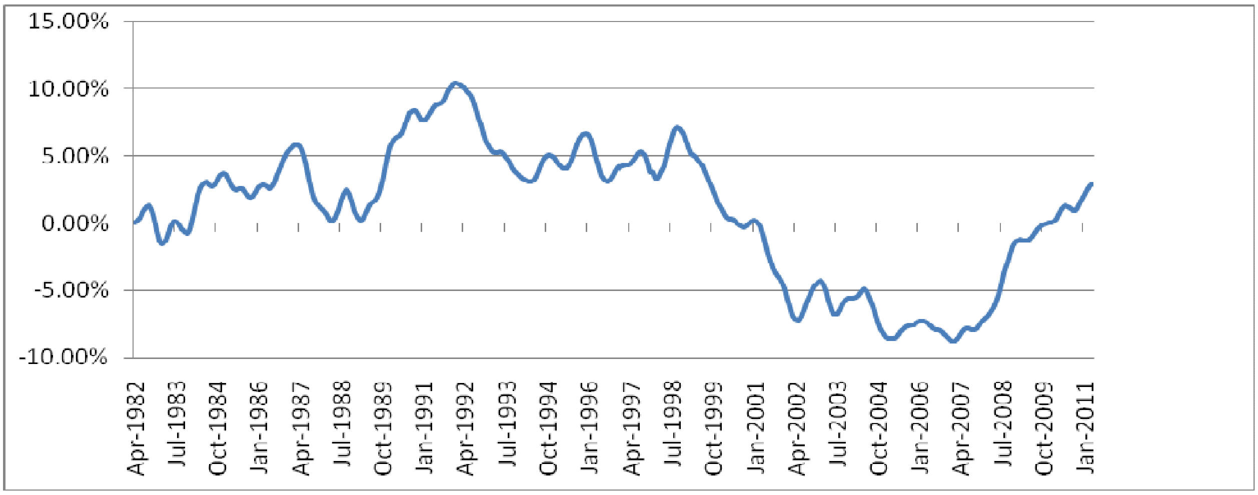
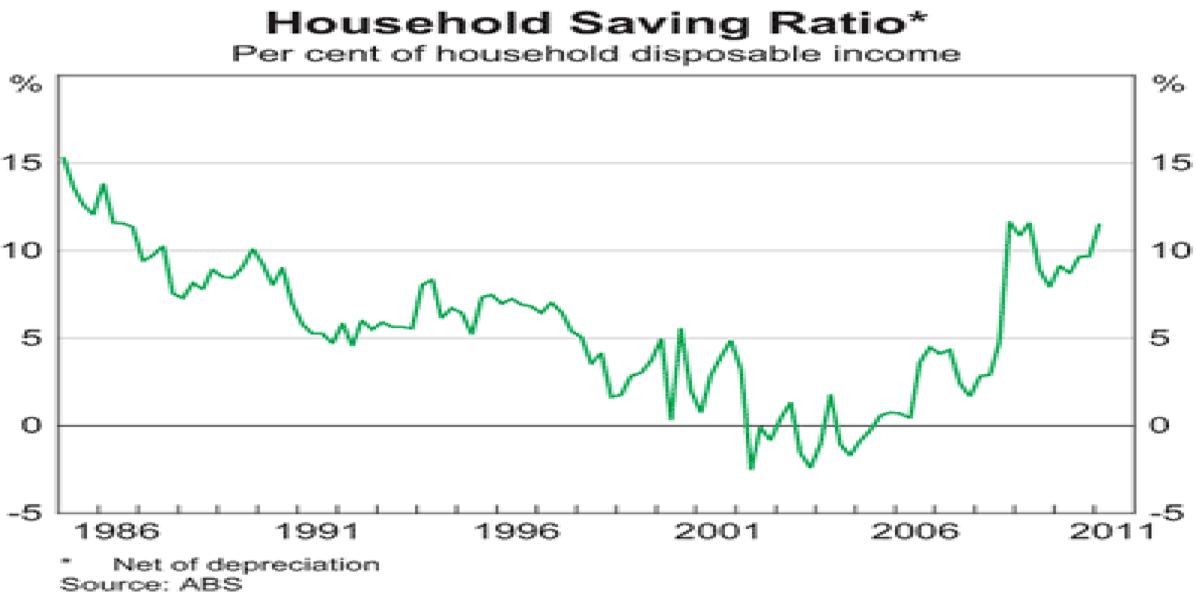
What is observable from the above chart is that household goods retailing while growing steadily, does not grow one for one with total retail sales. There are flat spots as evidenced by the current flat spot and periods in the late 80’s and then 90’s. I have graphed below the accumulated differential between growth in total retail sales and growth in household good sales – Harvey Norman’s market. As the line falls, spending on household goods and services grows faster than spending on total retail sales, and vice versa. The move from +10% to near -10% between the early 90’s until the 2002-GFC period, could indicate rising housing prices spurring household goods consumption, but it could also represent a significant uptake in computing and electronics (TV’s etc) that has occurred in the last 20 years. More recently though it is the reversion to par (0.00%) over the last four years that has caused debate.



Another chart worth considering is the national household savings rate below, which suggests we are now saving at rates near 30 year highs. It is interesting how similar the graph below and above are. I’m not sure exactly what it all means but I know households are gaining financial strength and becoming better positioned to return to the inevitable resumption of household goods consumption. And better still, Harvey Norman is especially well placed to take advantage.



Ask an economist or economic commentator to explain the reasons and causes for these swings in consumer behavior and you will inevitably get an answer. I just doubt how reliable those answers are in helping formulate what happens next. I prefer to concentrate on the long term

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trends which are obvious and cut the noise out. Alternatively we could take comfort that consumers will be back from a line in a Lily Allen pop song, "I am a weapon of massive consumption and it's not my fault it's how I am programmed to function".

<u>Harvey Norman as an investment</u>

So far I have expressed an opinion that Harvey Norman has a pretty good business model where sales growth is inevitable (but with variance) through the deployment of the integrated franchise and property system. I have also tried to highlight household goods sales, while sluggish currently (an example of the variance), will also ultimately rise again. What I haven't given is an explanation of exactly when it will happen and that is for two reasons; 1. I don't know and 2. Nobody else I have faith in knows either.

Instead, we can focus on what our investment could be worth given an expectation it will be worth more at some stage. Through time we know the level of Harvey Norman earnings from the Australian franchise business is impacted by three main levers; any additional sales the existing network makes (like for like sales growth), newly opened franchised stores adding sales, and thirdly the varying degree of support Harvey Norman provides the franchisees that results in the franchise fee margin. Below is a hypothetical look at what Harvey Norman could be earning before tax in five years time from the Australian franchise business under different assumptions.

		Profit before tax in five years?				
			Sales growth			
		3%	5%	6%	8%	like for like annual store growth
(millions)		$ 6,015	$ 6,625	$ 6,945	$ 7,525	resulting annual sales from existing store
		$ 600	$ 600	$ 600	$ 600	sales from new stores
		$ 6,615	$ 7,225	$ 7,545	$ 8,125	total sales growth
	4.0%	$ 265	$ 289	$ 302	$ 325	
	4.7%	$ 311	$ 340	$ 355	$ 382	
franchise	5.3%	$ 351	$ 383	$ 400	$ 431	
margin	6.0%	$ 397	$ 434	$ 453	$ 488	
	6.7%	$ 443	$ 484	$ 506	$ 544	

For Harvey Norman to be a worthy investment, it need possess durable earnings power, meaning there must be a level of franchise margin that can ultimately be relied upon to produce profits that yield satisfactory returns. The table on page six lists historical franchisee margins since the introduction of the GST. In those 10 years only once did we see a margin under 4.7% with the long term margins around 5.3%. These margins should be considered Harvey Norman's base earnings power and if anything possibly underestimates the position of Harvey Norman in the industry.

Looking at the financial year of 2011, a 5% franchisee margin looks likely with the first half of 2011 having already produced a margin of 5.6%. An annual franchisee margin drop of 1% (6% to 5%) will cost $50 million in profit before tax (PBT) so 2011 could produce $260 million in PBT. Add $80 million for property earnings and zero for company owned retail operations and Harvey

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Norman's group profit before tax is set to be around $340 million or $235 million after tax. Given 1,067 billion shares issued, that is 22 cents in earnings per share or 11X PER at $2.49. With a 2011 dividend of 12 cents there will be a fully franked yield of near 5%.

Moving to the hypothetical table and 2016:

- With a 4.7% long term average franchisee margin and 3% like for like growth $311 million in profit before tax is possible in 2016. Add unchanged property earnings of $80 million and a still zero profits from company retail, and an after tax profit of $275 million or 25.6 cents per share isn't unreasonable. Assuming a fully franked dividend yield of 4.5% (lower because of a return to growth), and a 13 cent dividend becomes a $2.90 share price. A move from $2.49 to $2.90 in five years is 3% growth per annum; add the dividend yield and an expected return of 8% per annum is likely.

- With a 5.3% long term average franchisee margin and a 5% like for like growth, $383 million in profit before tax is possible in 2016. Add likely property earnings of $120 million and a possible $50 million from company retail (assuming Ireland losses are reducing but not eliminated), and an after tax profit of $385 million or 36 cents per share isn't unreasonable. Assuming a fully franked dividend yield of 4.5% (lower because of a return to growth) and an 18 cent dividend becomes a $4.00 share price. A move from $2.49 to $4.00 in five years is 10% growth per annum; add the dividend yield and an expected return of 15% per annum is not out of the question.

Off the back of conservative forward assumptions we can see potential returns of between 8% and 15% annually by holding Harvey Norman at these levels. The above synopsis is no more than a hypothetical and there are many permutations that need be considered. There is no guarantee next year's earnings won't be lower - but equally there is no guarantee they won't be higher, or for that matter materially higher down the track.

To decide if Harvey Norman makes sense as an investment is to decide how sure you are that the business can first deliver (which is why we looked at the business model) and then think what earnings could look like down the track, and finally what the growth and dividends mean as a return.

The reports of my death are greatly exaggerated

Most people take their personal online retail experience as a consumer and extrapolate it out as to what that means for the future of retailing. Having bought something cheaper on the internet than through a bricks and mortar business they naturally assume traditional retailing must be dead or dying. To a degree I'm no different as I price everything on the net before buying and I mean everything (for research of course). I've bought a large variety of items online from a car to snow skis to dining chairs to sunglasses and even my toothbrush (true). It is also interesting what I haven't been able to buy cheaper on the net as compared to a retail store, for example; roof pod, computer screen, coffee and recently an oven. The trouble with this type of analysis is at best it can only provide clues as to the significance of the internet as a threat to traditional retail and at worst simply be misleading.

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Success of online operators such as ‘realestate.com.au’, ‘Seek’ and ‘carsales.com.au’ have so far come at the expense of traditional operators like Fairfax. My mind is not made up whether these particular online businesses are that terrific or if their successes are the result of the ‘duck’ effect. Charlie Munger mentioned “If you're a duck on a pond, and it's rising due to a downpour, you start going up in the world. But you think it's you, not the pond”. The obvious advantages the internet has over print in delivering these services, coupled with having to compete against the inept of the business world, meant online success was inevitable. But what happens once the online players are the only ones left and they start to compete against themselves?

With online retail there is an inevitable feeling that this same process will play out. We need only look overseas at the dominance of Amazon.com whose online sales since the GFC have grown $20 billion and with it earnings before tax of $0.9 billion. This would seem impressive until referenced against Wal-Mart whose sales and earnings have grown by $50 billion and $3.5 billion respectively during the same period. The real battle is player versus player not online versus bricks and mortar and in this game Wal-Mart is no Fairfax.

Locally successful online operators such as Wotif.com and more recently Catch of the Day, cudo or dealsdirect.com.au etc have a common theme. They are distressed inventory auction sites moving product they access cheap that they then sell cheap. The key here are the suppliers of the goods and services that have the products to move. Sure the internet and e-mail are perfectly cheap ways to sell to the price conscious – so it works. The strength of the online seller/retailer is at the expense of the weak position of the supplier.

To understand the threat to Harvey Norman from online retailers means understanding how a competitor would come into the industry and then out compete. Remember Harvey Norman promotes endlessly about cheap goods or discounts which drives enormous traffic through the stores as people chase a bargain. More advertising means more customers. Repeating the word ‘cheap’ or ‘bargain’ enough times works in driving customers into the stores which enables focused and highly motivated sales people to close sales – and here is the key – ‘at the highest price each customer will pay’, not the lowest. This maximizes profitability and causes high sales volumes (there is a price for everyone) resulting in suppliers needing Harvey Norman to sell their products or fear of missing out. Favourable buying terms result, leading to additional profits, which are then reinvested along with other gains from efficiency through scale into further promoting how cheap Harvey Norman sells – thus repeating the process. The bigger Harvey Norman becomes through the benefits of scale the truer the catch of selling cheap can become. This is what a new online competitor is up against.

The economic threat online retailer’s present is to force Harvey Norman to unwillingly sell all items at lower prices across the board, take meaningful sales volumes away impacting economies of scale and/or strengthen the bargaining power of suppliers when negotiating with Harvey Norman. These threats already exist from incumbent competitors but the supposed advantage internet retailers have in not paying rents or sales consultants is they can pass these cost savings to customers in the form of lower selling prices.

For an online retailer, meaningful lower prices will stimulate sales as the most price sensitive consumers scour for the best price. Yet lower gross profits leaves the online retailer with less funds to promote further sales growth, creating a Catch 22. Without promotion it takes a long time to build sales volumes necessary to create economies of scale. Without economies of scale to protect the low price advantage, the moment Harvey Norman price matches or even beats the price of an online seller, it diminishes the threat. So Harvey Norman splits the price conscious

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shoppers with the online retailers and through superior marketing and selling capabilities keeps the profitable customers. The longer it takes for this to change the more time Harvey Norman has to build market share and further economies of scale benefits enabling them to keep selling competitively when they have to or even better ‘at the highest price each person is willing to pay’.

The joker in the pack with regard to online and traditional retailing is suppliers, specifically manufacturers. It is far from clear how manufacturers are going to react to having their products sold traditionally versus online but suffice to say manufacturers won’t want their goods sold on price alone and this is to the disadvantage of online retailers.

Harvey Norman has operated in a very competitive market for a long time and that has shaped it into a fierce competitor. Hopefully this extended report provides some insight as to the thoughts and processes that go into making and holding an investment like Harvey Norman.

Finally, thank you for your support over the last 12 months and I look forward to the coming year. Please let me know if anything in this letter or that occurred during the year needs clarifying. My next letter will be early January 2012, summarising the first half of the new financial year.

Yours sincerely

Justin J O’Kane, CFA

PS. As always, I am happy to help your children, parents, friends and neighbors with their investments should they ever ask you, do you know a decent investment advisor? An endorsement of trust is always appreciated.