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O'Kane Investment Services Pty Ltd
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Dear Client

The close of the 2012/13 financial year marks the 10th year of OKIS client portfolio reported investment results. Over the ten years clients have experienced nine positive return years and one negative year, while the general market has had seven positive years and three losing years. I am pleased to report that this year we exceeded market benchmarks handsomely.

This report outlines the performance results for your portfolio(s) for the 2012/2013 financial year, starting 1 July 2012 and ending 30 June 2013. Enclosed is a position summary printout (amalgamated for clients with multiple portfolios) with end of period account balances, investment positions, estimated dividends for the next 12 months and asset allocation breakdowns. The usual cash transaction, trading history and dividend reports are also enclosed.

Please review the account records and let me know if you have any questions or would like to discuss any aspect of the report.

Your next report will be early September following the company reporting season.

Thank you for your support over the past year and I look forward to the coming year.

Yours sincerely

Justin J O'Kane, CFA

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Results for the 2012/13 Financial Year

Closing E*Trade account balance on 31 Dec 2013	**$**	**-**
less		
Opening E*Trade account balance on 1 July 2013	$	-
Change in the account balance	$	-
Adjust account balances for contributions and withdrawls		
less		
cash contributions from dividends debited into E*Trade ANZ CMT	$	-
add		
cash transfered out of E*Trade ANZ CMT	$	-
Change in account balance due to market price changes*	$	-
add		
dividends earned during the period	$	-
franking credits earned during the period	$	-
Portfolio Return for the period	**$**	**-**
Portfolio Percentage Return for the period		**0.0%**
* note: interest received and brokerage paid are included in E*Trade account balances		

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Portfolio & Market Review

Portfolio

In the 2012/13 financial year the Australian stock market (S&P 200) opened at 4,094 and closed at 4,802 for a gain of 17.3%. Add market dividends and franking credits (approximately 5.7%) and a portfolio 100% invested in stocks would have returned 23.0% below the average OKIS Absolute portfolio, which returned 31.1%. A benchmark portfolio invested 70% in stocks and 30% in cash deposits returned 17.2%, below the average OKIS Balanced portfolio, which returned 28.7%. A benchmark portfolio invested 50/50 would have gained 13.3% versus the average return from the OKIS Essential portfolio of 21.6%.

For a long time I have been advocating that not all businesses are created equally. Some have reliable earning power and grow profitably while others have not been sufficiently able to limit the effects of competition and their future profitability cannot be estimated with confidence. The better the business economics are the easier it is to value the business and the less risk there is to that value. As discussed in previous letters the earnings path that a company takes to attain higher future earnings is not as important as certainty that profits will be materially higher 5, 10 & 20 years from now. Hence we concentrate on 'IF' earnings will be materially higher in the future, rather than 'WHEN' they will be higher.

I strongly believe an investment portfolio full of stocks with superior business economics will outperform the general market over a long period of time. The unattractive alternative is to pick the direction of the market or pick winners from businesses with uncertain or lottery style economics.

This year the position summary print out attached to the letter divides companies into two new categories; stable and variable. The split relates to the purchasing behaviour of a 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. While a 'variable' business has customers whose buying routines and the prices they're prepared to pay for goods and services are less predictable.

The 12 month share price movements for the general market and the dozen most commonly held stocks (split between stable and variable) and other large cap stocks are listed below.

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		Yearly price change	Above/Below Market
MARKET INDEX			
ASX200	Top 200	17%	
STABLE BUSINESSES			
RHC	Ramsay	58%	Above
BXB	Brambles	52%	Above
IVC	Invocare	41%	Above
TLS	Telstra	29%	Above
WOW	Woolworths	22%	Above
WDC	Westfield	20%	Above
CCL	Coke	-5%	Below
COH	Cochlear	-7%	Below
VARIABLE BUSINESSES			
MQG	Macquarie	61%	Above
PTM	Platinum	41%	Above
HVN	Harvey Norman	31%	Above
BBG	Billbong	-86%	Below
MARKET LARGE CAPS			
WBC	Westpac	37%	Above
ANZ	ANZ	30%	Above
CBA	CBA	30%	Above
NAB	NAB	26%	Above
BHP	BHP	0%	Below
RIO	RIO	-7%	Below
WPL	Woodside	-11%	Below

Of the commonly held stocks from the list above you can see that there are more stable businesses than variable. As a general rule the stable business exhibit lower price volatility than the general market while providing superior long term performance. This dynamic means they should form the backbone of an equity portfolio designed to produce stable returns.

I remain comfortable with the client portfolios and valuations aren't excessive despite some stocks experiencing large 12 month 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 2013/14.

Specific discussion of individual stocks will be left until they report in August.

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Market

When 19th Century American financier J.P Morgan was once asked what the stock market will do next, he replied, "It will fluctuate". J.P Morgan was certainly right about 2012/13.

Making sense of market movements can be difficult as there seems to be a myriad of economic impacts and subsequent explanations that are important one day and nearly forgotten the next. Greece, gold and government deficits were last year's story while QE3 (quantitative easing for a third time) and China's economic wobbles are today's. How is an ordinary investor meant to make sense of it all? I would suggest it is only through the prism of value that we can observe the long term importance of what is shaping the market today.

Back when the Dow Jones was a lowly 200 (now 14,740) John Williams wrote 'The Theory of Investment Value' which sets forth the equation for value. "The value of any stock, bond or business today is determined by the cash inflows and outflows - discounted at an appropriate interest rate - that can be expected to occur during the remaining life of the asset". William's equation for value can be expresses as follows;

$$\frac{\text{Next Dividend}}{\text{Investors required return} - \text{Growth rate}}$$

Value can be distilled down to three key variables; the cash flow level due (Dividends), the rate at which the dividends will grow into perpetuity (Growth) and the annual percentage return you need to justify buying and holding the investment (The Investors Required Return).

Any time an important financial event, piece of economic news or change of sentiment happens we can judge what impact it will have on the market by referencing how the event, news or sentiment affects any variables.

Consider the third round of quantitative easing that kicked off in September 2012 and has had a large impact on financial markets, as has the recent news the Federal Reserve of America will start to scale back the easing. Quantitative easing is meant to work via the central bank purchasing long duration financial assets like mortgage back securities and bonds from US domestic banks and other institutions. By bidding up long term financial asset prices the Fed lowers long term yields and long term interest rates for everyone else. Lower rates stimulate economic activity and encourage the purchasing of assets as yield opportunities are sought. Quantitative easing moves the market by changing expectations on where interest rates are going.

At the beginning of the financial year our market was 4,094 and yielded 4.9% (4,094 X 0.049 = 200.6). Assuming a market expected return of 9% and a perpetual growth rate of 4.1% (real plus inflation) the market's value 'all else equal' would be…..

$$\frac{200.6 \text{ points}}{9.0\% - 4.1\%}$$

Answer is 4094 points

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Fast forward to the introduction of the USA Federal Reserve Bank's decision to introduce QE3 and we know rates will move lower in the USA and to some extent locally. Simply knowing rates will be lower is enough to raise market prices. We can see the impact in the model if we lower the investors required return from 9% to 8%.

$$\frac{200.6 \text{ points}}{8.0\% - 4.1\%}$$

Answer is 5143 points

As you can see the lowering of interest rate expectations increased the market value without changing either the cash flow now or by what the cash flow is expected to grow by.

When the Fed recently announced it intended to wind back QE3 measures, the lower rate effect had to be unwound. But, the Fed was unwinding the QE3 because it was anticipating increased economic growth. So, on one hand, the market will increase 'Investor return expectations' but on the other it increases 'Growth rate' expectations. If we adjust the equation for higher interest rates and growth we get the following result (don't forget we are now one year down the track so we need to adjust the dividends for the year's growth).

$$\frac{210 \text{ points}}{9.0\% - 4.55\%}$$

Answer is 4720 points

As you can see the market value has dropped for the changes in dividends, interest rate expectations and growth expectations because of the Fed's move to unwind QE3. Subsequently the market itself moved to reflect this change in value.

In theory, with our basic modeling tool understood, we should be able to interpret what impact new news has on the variables that influence the market. Unfortunately though, as good as this might sound in theory we now hit a road block. I have used precise numbers to explain the mechanics but in reality there is no such precision or consensus in the market as to what are appropriate levels for the inputs. The more precise we try and become in assessing every twist and turn with regard to interest rates and growth, the greater the risk we face of being precisely wrong in our assessment of value. Consequently, I take the attitude that as the values of the long term key variables are pretty stable through time, value is also pretty stable. That relegates much of what constitutes economic news to nothing more than market noise even if it results in market fluctuations that are sometimes large and fast.

If long term value is truly stable, yet market participants react to every slight deviation, then J.P Morgan, when asked what will the market do next, was right to answer 'it will fluctuate'.

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