

12 July 2005

Dear Client

Please find attached the following documents for the financial year 1 July 2004 through 30 June 2005:

- Cash Transaction History
- Trading History
- Account Positions
- Portfolio Report
- Realised capital gains and losses
- Dividends and Franking credits, ex-date

Total estimated gross gains for the financial year-end 2005 were \$ (\$ in 2004). This number includes all dividends, franking credits, realised capital gains/losses, unrealised capital gains/losses, interest received on the ANZ E*Trade CMT, brokerage costs but before management fees.

*Please note yearly gains can be reconciled back to the opening and closing balances of Securities and ANZ CMT by adding back to the year on year changes all cash received in any other bank account from dividends or capital returns plus cash withdrawn from the ANZ CMT, less cash deposited into the ANZ CMT plus then adding an allowance for franking credits. Because I do not have access to non-E*Trade ANZ CMT's I do not reconcile gains this way but the results will be exactly the same as the gross gains listed above. Franking credits are very important because it is the amount you have effectively prepaid the tax department. If it exceeds what you did need to pay then the tax department will refund the balance. Please note by only looking at changes in one component of the gains/loss equation e.g. changes in unrealised gains, you will end up with the wrong profit and loss figure.*

2005

2005 has not been as strong a performance as I would have liked. While we run roughly a balanced fund (55% equities and 45% income securities) it is still disappointing to not have done better, especially in light of the strong 2005 market. The strongest part of the market rally this year has been in sectors that are highly cyclical and unpredictable. Namely bulk commodities, oil and insurance companies. These sectors historically struggle to provide sufficient long-term return to investors but can outperform in any one given year – this year they have shone. Namely Woodside +70%, Rinker +69.5%, BHP +44%, Wesfarmers – coal driven +33%, QBE +30.6% and Suncorp +47%. It should be well known to all clients these are areas I tend to shy away from due to their unpredictable nature – but that has cost this year. What the future holds for these sectors is as unpredictable as the past. We have not tried to mimic the index so in any given year we are likely to have different equity returns from the index, 2004 was better, 2005 worse. Another point of interest is an article I have attached which tries to explain the Australian market out performance in the last year. It concludes that while the rest of the world indexes went sideways Australian investors just kept paying up for earnings that are cyclical in nature instead of discounting the cyclical aspect. Either Australia is wrong or the rest of the world is wrong!

While it never feels good to miss the hot sectors I believe the under performance is more attributable to errors made in areas of supposed strength. Playing the percentages correctly makes year in year out strong investment gains a possibility, and in that regard I see some errors having been made this year. A few stocks sold too early, a couple of stocks overlooked and a couple of stocks bought too early all add up to missed opportunities that would have been worth more than the risk of having invested in any hot sector. I'm not sure anyone can pick the next hot sector but if we can get the basic ideas right there are ample opportunities to obtain above average gains. Some of the misses are as follows:

- MBL was probably the biggest move of the top line stocks in the year (approx 80% gain) and we had the equivalent of two holdings. Exiting the position at an average of \$46.80 instead of the current price of near \$60 has chopped approximately 2% or \$6,000 off the annual return. MBL was not expensive at \$46.80. On a smaller scale the premature sale of CAB has cost close to 0.5%. Both MBL and CAB are strong businesses with economic characteristics that are difficult to find at good prices. We had both of them at good prices (regardless of a strong or weak market) and let them go in the attempt to out play the market. Neither was outrageously expensive.
- Selling Santos early has been expensive. With the oil price the key driver behind STO's price rise the early exit has cost around \$4,700 or 1.5%. Attempting to lock in the gains has been expensive and the position would have been best served to let run its course.
- Buying into stocks wanted early has also cost, ABB, ARB and IFM (mainly) has also cost about 1.5% in returns. While all stocks are wanted the buy price could have been timed better. We would still hold the same businesses with the favourable economics but at lower prices and more stock to our name.
- Finally the last couple are stocks missed out on. Missing Cochlea and Leighton while both were at buying opportunities has been expensive. COH has virtually doubled while LEI is up 50% from buying levels. These misses are expensive, anything up to 4% of portfolio returns.

As can be seen we didn't have to be on the hot sectors to have market performed or even outperformed. Instead all we needed to do was play the percentages to the original game plan of buying quality businesses at fair prices and average business at low prices. Getting a few of these right makes all the difference.

As a side point making losses on some stocks are not what I call mistakes. In order to make gains some stocks will be bought that perform poorly on the scoreboard but they are the cost of finding winning stocks.

By my estimates the average balanced fund returned 12-13% in 2005 (three year average 8.5%) and we did about 9.5% in 2005 (approx 21.5% 2004). Yet we probably have left as much as a further 10% on the table as indicated above, and that is more or less independent of hot sectors.

2006 requires renewed discipline and with that will produce better returns.

If you have any queries regarding the reports posted or would like an electronic copy please call me.

Kind regards

Justin O'Kane