

11 July 2006

Mr

Dear Client

Today's letter contains relevant information for the financial year ending 30 June 2006; it has all the necessary reports, results and commentary for your perusal.

- Investment Review of 2005/06
- Financial Results 2005/06
- Investment Positions as at 30 June 2006
- Attached Reports 2005/06
- Commentary
- Outlook.

## **Investment Review of 2005/06**

*Rule No.1: Never lose money. Rule No.2: Never forget rule No.1.*

**Warren Buffett**

The financial year 2006 proved a positive year for portfolio returns. We had some strong investment performers, some solid investment performers and some big investment price turnarounds. Meanwhile this all happened against a backdrop of many other steady investments that just keep bringing in the cash in the form of continued dividends and interest payments. As will happen every year amongst our winners we also had other investments that disappointed in either stalling or just going backwards. Portfolio gains are all important but they must be considered in the context of the risk taken onboard to generate them. From this perspective our portfolio return has been satisfying given the equities/income securities balance held.

Harvey Norman proved a big winner notching up 60% gains over the year while we saw value from our listed investment companies TGG (+35% including dividends) and CYA (+26% including dividends). Meanwhile NAB, WBC and WOW made healthy year on year gains along with other investments. Strong turn around and improvements from MRL (+118%) and IFM (+42% including dividends) returned capital previously adrift. (Note these gains are by comparison with last year's closing price, then used to calculate last year's returns.)

On the flip side Telstra and Flight Centre gave up ground during the year. Both are investments still required and while they have reduced capital gains this year they have plenty of potential to generate gains into the future.

The equities market in general as measured by the S&P 200 advanced during the year from 4277 to 5074, which is a 796-point gain. This would suggest that the broad market had much success. But you might be surprised that such a statement would be misleading. 2005/06's market gain, similar to 2004/05's, was heavily concentrated in just a few stocks. BHP alone contributed 207 of those 796 points or 26% and when added to RIO's and Woodside's gains that percentage jumps to 37%. Add to that the banking cartel of CBA, NAB, ANZ and WBC (163.4 points) and those seven stocks alone contributed 57% gain of the total market gain, not really a very broad based spread at all. In fact over 81% of the total market advance can be attributed to just 18 stocks. This should not be interpreted as a particularly healthy state of affairs when you consider the foundation of those gains i.e. copper prices to USD\$4 a pound from a low of 90 cents, iron ore prices at levels not sustainable for the steel industry and banks who have never lent more money to more people at higher asset prices with lower allowance for bad debts in an interest environment that is rising against a background of intensifying banking competition. The capital appreciation has been there but no one asks the question at what risk and will gains hold should the favourable winds they operate in now blow the other way.

For investors prepared to think about both return and risk at the same time there are alternative ways to generate returns with an appropriate amount of risk, hence the structure of our portfolios (for example HVN 60% share price gain was exactly the same as BHP 60% gain but without the risk of commodity fluctuations). I have no doubt we will be investors of some of those big stocks in the future but only when the risk reward balance is in our favour.

Meanwhile, in debt markets (relevant for the income securities that are part of our portfolio sheltered from equity price changes) all interest rates moved higher with the biggest and most significant move in long-term rates. The 90-day bank bills, 3 year and 10 year swap rates moved from 5.66%, 5.53% and 5.59% to 5.92%, 6.2% and 6.25% respectively. When long-term interest rates move up all asset values should adjust down accordingly or the riskiness of an investment in assets has just increased. Such is the reason why the USA equities market could barely generate a 5% return while world markets soared.

Locally the biggest risk for debt markets relates to inflation and the gap/reward we get for effectively lending to companies over the risk free rates. To combat this we are mainly holding floating rate notes that change their interest rate payments with the 90-day bank bill or holding securities with a maturity of less than two years so any spread widening can be ridden out.

*(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.)*

## **Financial Results 2005/06**

**Your approximate gain for the financial year ending 2006 has been \$.**

Capital gains realised over the year	\$
Capital appreciation over the year	\$
Dividends over the year	\$
Franking Credits over the year	\$
Cash interest over the year	\$
Less brokerage over the year	\$

## Positions

Opening account balance on 1 July 2008	\$	-
less withdrawals during the period	\$	-
less closing account balance on 31 Dec 2008	\$	-
less dividends and franking credits earned during the period	\$	-
net change for the period	\$	-
% change from the opening balance		
Closing account balance on 31 December 2008	\$	-
add withdrawals during the period	\$	-
add dividends and franking credits earned during the period	\$	-
less opening account balance on 1 July 2008	\$	-
net change for the period	\$	-
% change from the opening balance		

**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.

**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 i.e. be purchased where there is a margin of safety between what is paid and what we receive.

## **Attached Reports 2005/06**

The attachments contain the following information:

- E\*trade PDF file; 2005/06 E\*Trade cash transactions, trading history and EOY position.
- My Spreadsheet; dividends, franking credits and capital gains for all years. 2006 has been colour coded.

### **Notes as to the usefulness of the reports:**

Note 1. The E\*Trade PDF EOY file is generated on a cash only basis and as such does not take into account any unsettled transactions i.e. any purchase or sale done on the last two days of the financial year whereas my portfolio summary does.

Note 2. 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 and brokerage. 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 they are amounts you effectively prepaid the tax department. If it exceeds what you needed to pay then the tax department will refund the balance via a correctly completed tax return. 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 yearly gains figure.

Note 3. The spreadsheet provided contains dividends (ex-dividend date only – not payment date), franking credits and capital gains and losses used to help me determine approximate yearly performance and is not intended to be solely a tax calculation instrument. While it should prove to be very useful it needs to be compared against your own dividend records and estimates of capital gains in determining your tax situation. Shortcomings include but are not limited too:

- In the case of dividend reinvestment I enter a zero figure for the dividend column as the benefit is picked up as zero cost shares in unrealised gains. So when the stock is eventually sold I use the averaged down cost base for capital gains. While this works out for tracking performance it is not appropriate for taxation purposes.
- In the case of capital returns e.g. SGN's 27 cents per share capital return this figure is recorded as a capital gain in the spreadsheet but there is no capital gains tax payable until the stock is sold in which case the 27 cents is deducted from the cost base for tax purposes.
- Other differences include brokerage treatment and accrual vs. cash treatment of dividends.

Consequently the spreadsheet provided has reduced taxation usefulness, as its objective is predominately to help me track your approximate gains/losses per annum. If needed please call me directly for any clarification regarding an entry on the spreadsheet.

## **Commentary**

*We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful. Warren Buffett.*

Contrary to common thought, what really matters in assessing portfolio performance is not price changes of the stocks in the portfolio year to year, but the changes in net intrinsic value of the businesses that make up the portfolio. Price often proves temporary while value should be permanent.

When divergence starts to emerge between price and value (or substance) a similar gap opens up between risk and reward. After three years of market gains matched by three years of profit growth it would appear on face value that the price and value equation today is in equilibrium unlike the tech boom where the mismatch was poignantly obvious (especially with hindsight). The question is should we accept on face value this current equilibrium or delve a little deeper to see if we have reason to fear the current price and value proposition.

The most common argument for the market equilibrium (risk and return balance) is that the current market PER (price earnings ratio = share price divided by earnings) is not excessive by historical standards so therefore everything is all right. The equilibrium argument goes that the long term PER of the market is about 15 or 16 times (15X or 16X), with recent years ranging from 12X to 20X and we currently are about 15X today. So therefore the market value is not out of line with where it should be.

Where this argument falls down and becomes dangerous is that the 'E' or earnings part of the PER is a variable just like price. Earnings are the net result of the difference between revenues and costs where the difference can be expressed as a profit margin. Profit margins have increased significantly over the last three years for many listed companies, which has increased company earnings and in turn resulted in increases in share prices leaving the PER more or less constant.

Due to the competitive nature of business and cyclical nature of customer demand profit margin increases are not always sustainable perpetually. Profit margins change year to year and in the last three years they have gone from depressed to buoyant, and this is where risk raises its head. Any contraction on operating margins will result in a contraction in earnings and the share prices will drop to keep the PER constant at around current levels. So what we should really be concentrating on to determine market risk is not price alone but risk to earnings margins. I have seen virtually no reporting on this issue for the market as a whole in the financial press but plenty along the PER line.

What effects operating margins? In the big picture operating margins of an industry or company are a function of the: bargaining power of customers, bargaining power of suppliers, rivalry amongst existing firms, threat of new competitors and the threat of substitute products or services. Over time the interaction of these variables determine profit margins. Given many industries/companies operate with reasonably high fixed operating costs, any time customer demand races ahead of competition margins will significantly increase. Ultimately though higher profitability attracts new competitors, substitute products, higher supply prices – of which labour costs are an example and finally, increased competition amongst existing firms. When costs increase faster than revenue, profit margins will fall and so will the share prices.

So with this background we need to take into consideration the current and developing operating risks and see what is actually happening out there. The following are examples of cost and competitive pressure that have been reported so far in 2006. Some factors have already affected the share prices and others are yet to be felt in the share price of stocks.

### **Health care and pharmaceutical sector:**

- The Queensland government has just awarded a 10.6% increase in wages for nurses, doctors and allied medical staff.
- Increased competition in pathology services companies between themselves and from public hospitals looking to utilise facilities.
- Public sector diagnostic imaging technicians in NSW were recently awarded a wage increase of more than 20%.
- Federal Government looking to save money by making generic medicines the preferred drugs available thus effecting pharmacy and pharmaceutical wholesalers margins

### **Food, beverage and retail consumer staples:**

- Lion Nathan is reporting rising raw materials prices in aluminium and sugar that can't be recovered by product price increases.
- Goodman Fielder and George Weston are facing more than 20% input cost increases in yeast, which follows a 15 to 20% increase in transport costs.
- Coca-Cola Amatil has forecast 6-8% increase in cost of goods sold, namely sugar, aluminium, PET and fuel.
- The Beef industry faces a renewed competition threat in sales to Japan as the USA re-enter the Japanese market for the first time since 2003. Australian market share had grown to 90% of the Japanese market and faces a 25% loss.
- Companies selling managed investment schemes in timber products face headwinds as they have pushed the price of usable land to prohibitive levels.
- Metcash face potential rivalry from Franklins who are setting up their own wholesale grocery operation. Franklins is owned by a very deep-pocketed South African operation.

### **Media/advertising:**

- Total media spend has grown but online advertising revenue has started to cannibalise other mediums. Internet advertising revenue has grown to over one billion dollars (currently newspapers \$3.8 billion and free to air TV \$3.2 billion). With fixed cost bases the traditional media companies have had margin compression. While this sounds good for Internet companies', the reality is their expanding margins are susceptible to a fight back from traditional sources as they try and hold their ground.
- Margins for companies like Ten, Nine, Southern Cross have been hammered. Last year Ten had an operating margin over 40% and now it is at the mid 20's and hence the share price has gone from \$4.40 to \$2.60. It doesn't make these bad companies at these prices but it shows the danger of paying high stock prices when operating margins are abnormally high.

### **Capital goods and mining:**

- All eastern state governments have gone into budget deficit to fund state infrastructure projects. It is commonly reported about the cost over-runs for these projects is high as they compete for the same labour, capital equipment and know how. While this should bode well for supplying service companies they run the risk of cost blowouts themselves with rising labour costs and subcontractors. After all one person's revenue is another's operating cost. In the meantime engineering companies are enjoying massive earnings multiple ratings for earnings growth that at best will be cyclical.
- The state government projects are also conflicting with listed companies projects with BHP, RIO and others delaying revenue generating projects due to cost overruns. This implies lost revenue opportunities in buoyant times.

- Mining company margins have expanded enormously with BHP and RIO experiencing margin growth from 20% to 40% over the last couple of years. Supporting this have been copper price rises from USD\$2000 a tonne to USD\$6000 a tonne, aluminium from USD\$1200 a tonne to USD\$2400 a tonne, gold from USD\$350 an ounce to USD\$600 an ounce and iron ore fixed contract prices up over 100% in the last 18 months alone. Input costs for these companies in energy costs, wages, subcontracting and expansion costs will put the extreme operating margins at risk going forward. Commodity price movements will continue to be unpredictable as always with more open speculative positions than ever before in trading history.

### **Banking and insurance:**

- The big four are giving away a lot of pricing power, from deposit rates to paying brokers to arrange housing loans. The saviour for banks recently has been the strong growth in business lending, but as the RBA noted variable business rates and official cash rates have narrowed to about 2.5% from 5% a decade ago. Further proof of increased competition.
- After enjoying many years of increased premiums due to the HIH collapse and 9/11 while operating in benign environment competition has returned to the insurance sector. Local and foreign competition plus lower future investment returns are putting the industry margins under pressure.

While it might sound all doom and gloom, in reality the picture is rarely clear-cut. The key is not to forget the risk to operating margins is increasing at a time many investors have forgotten that you can actually lose money from owning investments. Hence the desire to position portfolios where the upside will be generated by improvement in the long-term business value not just from a run up in the share price because of favourable (but reversible) operating environments. Operating outlook comments for 30 June profit announcements will go a long way to identifying the timing of this risk.

### **And The Outlook Statement**

*We believe that short-term forecasts of stock or bond prices are useless. The forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.*

**Warren Buffett**

The previous 12 months saw lower portfolio turnover (stocks bought and sold) than any previous period. This reflected an enforced contentment with the position because of a lack of obvious new opportunities. Being inactive is not always dumb. Considerable volatility has returned to the market in the last couple of months and increased volatility is usually associated with market turning points. As a consequence I would expect the up coming 12 months to throw up a number of opportunities while the first week into the new financial year has seen solid gains for portfolios.

If you have any queries regarding anything discussed please call me directly.

Kind regards

**Justin O’Kane**  
**Portfolio Manager**