AAA Shares Pty Ltd AFSL 222138
ABN 44 008 180 952

O'Kane Investment Services Pty Ltd
Portfolio Management
ABN 66 101 935 737
OKIS.COM.AU

18 July 2008

Dear Client

2007/08 has proven to be a very difficult year with the market falling heavily following concerns over the global credit market crunch and the oil price spike. Consequently the enthusiasm shown over the last five years bull-run has turned to severe pessimism with the market now pricing in a recession ahead of time into all sectors of the market, bar the mining sector. The market closed on 30 June 2008 at 5215, as measured by the S&P200. From this financial year's November high of 6850, the general market is off 24%. From the start of this financial year, 6275, the market is down 17% with financial stocks down 32 per cent, listed property trusts tumbling 38 per cent, utilities having dropped 32 per cent and industrial companies slumping 35 per cent. This report will detail your portfolio's performance, current position and discuss what happened, why it happened and where to from here.

Financial Results 2007/08

Your gain/loss for the financial year 2007/08, being 1 July 2007 to 30 June 2008, before taxes and fees, has been **$**.

Opening account balance on 1 July 2008	$	-
less withdrawls 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		#DIV/0!

Closing account balance on 31 December 2008	$	-
add withdrawls 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		#DIV/0!

507/566 St Kilda Road, Melbourne 3004. Mailing Address: 72 Queens Avenue, Caulfield East Vic 3145
Email jjokane@aaashares.com.au Ph 03 9016 8989 Mob 0403 857 290 Fax 03 9526 8104
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230150) are Authorised Representatives of AAA Shares P/L (AFS 222138)

For those with a liking of financial accounting, the accrual breakdown details are as follows:

This brings your total gains since we started our association to approximately $ (before taxes and fees).

Market and Portfolio Review

(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.)

At the beginning of and during this financial year our portfolios held a combination of stocks and income securities/cash that were expected to provide some kind of protection against a market downturn and/or add value if the market kept running away as in 2006/7. So what happened in 2007/8? This year's portfolio performance can be explained by the interaction of three separate factors that individually, had extreme effects on our returns, yet when combined, resulted in approximately market level related losses for the more aggressive portfolios and lower losses for the more conservative portfolios, which on face value was not what we had planned.

1. First, the general market loss of 17% hides the harsh reality of what actually occurred during the year. Many industry sectors had their yearly stock prices absolutely decimated with losses of 35% common and that is from the start of the financial year prices, not the highs. It was only the mining/materials sectors gains that brought the average general stock market losses down to 17%, otherwise we could well have had a general market fall of 35% this year. For example consider this list: AMP off 35%, ANZ off 38%, IAG off 38%, MIG off 36%, Newscorp off 40%, Suncorp off 35%, Tabcorp off 38%, TOLL off 58% - all top 20 companies, and consider these well known names: Babcock and Brown off 77%, ABC Learning off 88% and Centro off 97%. These were not small companies as they had market values last year of $8, $3 and $7 billion respectively. We have not been spared in this rot with many of our stocks significantly off from last year's prices. Harvey Norman 40%, Infomedia 40%, STW Communications 54%, Wilson 40% and new stocks BBC 59% and Platinum 44%. Now some of these price falls are justified and others are

not and are the result of the market meltdown i.e. baby and the bath water syndrome but more detail on that later.

2. As suggested, the reason the general market was not off 35% and closer to down 17%, is the continued fearless faith in the stronger for longer and now stronger forever belief in rising material prices. This market sector finished higher which offset other sectors' losses and now represents the largest sector in the S&P200. By deliberately avoiding these sectors we received no benefit or protection here (except for SOL via its New Hope coal exposure). I don't back away from this decision and will discuss whether this is justified, right or wrong and reasonable later.
3. Finally what we got right in the portfolios this year and reduced our average losses was the decision to not be fully invested in stocks by holding either cash or income securities or both in large amounts. This offset the devastation in the industrials etc and lack of exposure to the miners/materials by limiting how much of our funds were exposed. This was our deliberate plan to reserve part of our portfolio to cushion against what we knew to be extended valuations and risk in the market.

In combination the above factors resulted in a portfolio performance loss approximating the general market for the more aggressive portfolios and lower losses for the more conservative portfolios based on 1 July 2007 account balances. I have said many times what counts is not relative performance but absolute returns and this has been an absolutely tough year. I suspect that if we are to have strong returns in three to five years forward resulting from the accumulation of successful business purchased at reasonable to low prices then unfortunately to paraphrase Paul Keating's infamous phrase 'this is the stock crash we had to have'.

Investing 101

From a little over six months ago when people couldn't get enough of shares because of an optimistic opinion of the future to now with many shares approaching half their price for fear of a 1929 like recession we have witnessed some very dramatic price movements. It can be very hard to cope with extremes in price movements (both up and down) so it helps to have an understanding of what causes share price movements in the first place.

Driving share price swings is a valuation process carried out by the market on mass resulting in a consensus opinion about the value of each company. When the market consensus of a shares value changes the price changes to reflect the new mass opinion and it moves up or down accordingly. If the earnings changes turn out to be real then the price forms a new base. There is a lot of market noise surrounding this process but at the end of the day that is what happens. The question becomes how much of the consensus opinion (hence share price movement) is real and how much reflects hope, fear and greed.

The best way to understand this process is via a definition of value (hence market price via consensus) and then run through an example. To get us going I have lifted the following from Buffett's 1992 letter to shareholders as it gets to the heart of how value is determined.

"In The Theory of Investment Value, written over 50 years ago, John Burr Williams set forth the equation for value, which we condense here: *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.* Note that the formula is the same for stocks as for bonds. Even so, there is an important, and difficult to deal with, difference between the two: A bond has a coupon and maturity date that define future cash flows; but in the case of equities, the investment analyst must himself estimate the future "coupons." The investment shown by the discounted-flows-of-cash calculation to be the cheapest is the one that the investor should purchase - irrespective of whether the business grows or doesn't, displays volatility or smoothness in its earnings, or carries a high price or low in relation to its current earnings and book value."

Or put another way as he did in 1989:

"What counts, however, is intrinsic value - the figure indicating what businesses are rationally worth. With perfect foresight, this number can be calculated by taking all future cash flows of a business - in and out - and discounting them at prevailing interest rates. So valued, all businesses, from manufacturers of buggy whips to operators of cellular phones, become economic equals."

There are many variations (most of them short cuts) to the above valuation technique but it does not matter whether you use a discount dividend model, free cash flow model, residual income model, Gordon growth model, two staged, three staged, H-model or multi-staged or justified price to earnings (PER), price to book, price to sales, price to cash flow or any other method to discount future cash flows (including terminal values) they will all lead to the same value assuming the same inputs. And that is because they all have the same drivers – estimates for return on equity, growth rates and required rates of return (discount rate/time value of money).

So in its most basic and correct form the total value of any business is the lifetime of cash/profit the business can spit out after paying for expenses, taxes, capital equipment, working capital and the cost of growth. All these future yearly cash flows occurring over the lifetime of the business (10, 20, 30, 40+ years) are then discounted for the time value of money. Simply add all the yearly values together, subtract debt, and you are left with the value of the company.

Via a simplified example we can observe the mechanics and effect on price a change of consensus opinion has. Suppose a business was going to make $10 million profit every year forever (in this example a business life of 50 years is used) and it had no debt and the time value of money was 10% (linked to long term interest rates plus a premium for investing in equities). As detailed in the example below:

You can see the value of the business is $99.15 million which is the sum of every year's profits discounted for the time value of money. A short cut would be to use a PE ratio of 10 times next year's profit and it would also give you a business value of $100 million…pretty close. Observe how year 1 and year 2's contribution to the total value is just 17% of the overall business value (i.e. $9.09 plus $8.26 = $17.35).

Next for whatever reason let us assume the market now expects this same business to grow at 7% per year instead of no growth. You can now see the changes in profit expectations.

507/566 St Kilda Road, Melbourne 3004. Mailing Address: 72 Queens Avenue, Caulfield East Vic 3145
Email jjokane@aaashares.com.au Ph 9016 8989 Mob 0403 857 290 Fax 03 9525 8104
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230150) are Authorised Representatives of AAA Shares P/L (AFS 222138)

year	profit	discount	$ 249.69	year	profit	discount		year	profit	discount	
1	$ 10.00	91%	$ 9.09	18	$ 31.59	18%	$ 5.68	35	$ 99.78	4%	$ 3.55
2	$ 10.70	83%	$ 8.84	19	$ 33.80	16%	$ 5.53	36	$ 106.77	3%	$ 3.45
3	$ 11.45	75%	$ 8.60	20	$ 36.17	15%	$ 5.38	37	$ 114.24	3%	$ 3.36
4	$ 12.25	68%	$ 8.37	21	$ 38.70	14%	$ 5.23	38	$ 122.24	3%	$ 3.27
5	$ 13.11	62%	$ 8.14	22	$ 41.41	12%	$ 5.09	39	$ 130.79	2%	$ 3.18
6	$ 14.03	56%	$ 7.92	23	$ 44.30	11%	$ 4.95	40	$ 139.95	2%	$ 3.09
7	$ 15.01	51%	$ 7.70	24	$ 47.41	10%	$ 4.81	41	$ 149.74	2%	$ 3.01
8	$ 16.06	47%	$ 7.49	25	$ 50.72	9%	$ 4.68	42	$ 160.23	2%	$ 2.93
9	$ 17.18	42%	$ 7.29	26	$ 54.27	8%	$ 4.55	43	$ 171.44	2%	$ 2.85
10	$ 18.38	39%	$ 7.09	27	$ 58.07	8%	$ 4.43	44	$ 183.44	2%	$ 2.77
11	$ 19.67	35%	$ 6.89	28	$ 62.14	7%	$ 4.31	45	$ 196.28	1%	$ 2.69
12	$ 21.05	32%	$ 6.71	29	$ 66.49	6%	$ 4.19	46	$ 210.02	1%	$ 2.62
13	$ 22.52	29%	$ 6.52	30	$ 71.14	6%	$ 4.08	47	$ 224.73	1%	$ 2.55
14	$ 24.10	26%	$ 6.35	31	$ 76.12	5%	$ 3.97	48	$ 240.46	1%	$ 2.48
15	$ 25.79	24%	$ 6.17	32	$ 81.45	5%	$ 3.86	49	$ 257.29	1%	$ 2.41
16	$ 27.59	22%	$ 6.00	33	$ 87.15	4%	$ 3.75	50	$ 275.30	1%	$ 2.35
17	$ 29.52	20%	$ 5.84	34	$ 93.25	4%	$ 3.65				
									TOTAL		$ 249.69

Now the business has a higher value of approximately $250 million because profits are anticipated to grow. The next two years of profit represent only 7.2% of the total company value and the business is worth 2.5 times the no growth example just because of a change in view about the future. This might be a simplified example but this is what really happens via the complexities of the market. What we are now seeing is obviously the reverse with growth assumptions being stripped out of valuations. Adding pressure is the recent increases in interest rates meaning higher discount rates or a higher time value of money further lowering valuations.

There are two key points to take out of this example that highlight biases that lead to significant market swings.

- First, the next couple of years profit which the market thinks it has vision of and places enormous weight on in estimating all future year growth prospects only represent a small proportion of a business's value so we shouldn't get too excited or pessimistic either way about what we think we can immediately see. The value is in ALL the future cash flows, most of which are determined by long term industry and business specific so whatever influences (e.g. market position, profit margins, return on equity etc) is what we should concentrate on.
- Second, when the market is too optimistic it prices stocks too high on growth expectations and when it is too pessimistic the market prices stocks too low on little growth expectations (even negative ones) when in reality the truth rests some place in between. The effect of changed expectations away from long term average sustainable growth levels is to see significant share price and market swings when those views swing around. Real profit growth we have seen over recent years was extrapolated into the future to support optimistic stock prices and now we are witnessing severe price declines because no growth is being extrapolated into the future. It has been a long time since the market has been in equilibrium.

From the above simplified example we can note how fickle the valuation process is. Market participants in their haste to be right all the time and never appear to be wrong switch and swap their opinion to reflect what appears immediately obvious whereas it would be far better to be roughly right than precisely wrong. Add to this the market emotions of greed, fear and hope (i.e. sentiment) and the market swings are even more pronounced. How else do you explain a market that has moved 9000 points up and down from two years ago but is now only 100 points away from where it started, while only having a value of 5200 points in the first place? The only way to overcome the extremes of the valuation process is to assume robust assumptions about growth that look through the ups and downs of short term events. The market will never do this but as investors if we are to succeed and generate the returns we deserve this is what we must do.

A closer look at the businesses in our portfolio

I can't provide a logical or neat answer for why individually many of our stocks prices are so depressed. What I can say is that for their prices to be justified many of our stocks will have to have their future profits become and remain severely depressed. In fact so harsh has been the selloff that many will have to halve their current earnings and stay depressed for many many years to justify their current market prices. Neither of which is likely. What else I can do is go through a number of the businesses we own and explain their market position, the key drivers behind their revenue and profitability, show their record of success and discuss what has impacted their fortunes through economic ups and downs. From there you should be able to decide if you see a good business whose long term future is sure.

Ultimately we want to own a portfolio of businesses with strong market positions in their respective industries. They are either able to service customers better than competitors because of quality products/services they have developed or because they can sell cheaper and more extensively than their competitors. Also they are able to take advantage of their suppliers or at least not have their profitability overly influenced by them. In carrying out their activities they use relatively low amounts of capital ensuring high returns on capital so that when they find growth opportunities profits are still available to be distributed as dividends and not all sucked up in growing.

Flight Centre (FLT)

We own FLT because of the dominant position it holds in the distribution of private and corporate travel products and the benefits that a strong market position brings towards earnings growth and dividend increases. Because FLT is able to sell/distribute such a significant volume of travel needs it is able to extract good commissions from the suppliers dependent upon it (like Qantas, United Airways etc) and to service its customers well enough that competitors struggle to match their prices on a consistent basis. FLT has been able to become such a dominant market player because management has instilled a sales, service and corporate culture of rewarding what gets done. FLT's fortunes are linked to the total travel it sells and below is its record and the resulting earnings and dividend on a per share basis.

	2008	2207	2006	2005	2004	2003	2002	2001	2000	1999
Total FLT turnover ($billion)	$ 10.5	$ 8.9	$ 7.8	$ 6.9	$ 5.9	$ 4.5	$ 3.6	$ 3.0	$ 2.4	$ 1.8
- yearly growth	18%	14%	13%	17%	31%	25%	20%	25%	33%	
- income margin	13.4%	13.0%	12.7%	13.0%	13.2%	13.3%	13.0%	12.8%	12.3%	11.7%
Earnings P.S(cents)	151.2	96.6	84.6	71.9	89.4	76.4	71.1	51.8	49.2	35.1
Dividends P.S(cents) 100% franked	89.5	66	52	50.5	101	43.5	37.4	87.4	24.9	17.9

Over this period FLT has successfully navigated a path of earnings growth against a backdrop of the September 11 terrorist attacks, SARS, introduction of internet sales competitors, and sustained higher oil price rises. I'd say a couple of those issues are the economic equivalent of a recession for a travel distributor – and FLT got through them just fine. On the flip side they have benefited from the high Aussie dollar making overseas travel attractive. I don't know what will happen to travel volumes in the immediate future but I seriously doubt over any sustained period that people are going to travel less than they are today in the same way as people are travelling more than ten years ago and ten years before that. The trend towards increased travel will outlive any economic condition we may currently fear and FLT continues to be best placed to capture the profits to be made out of that.

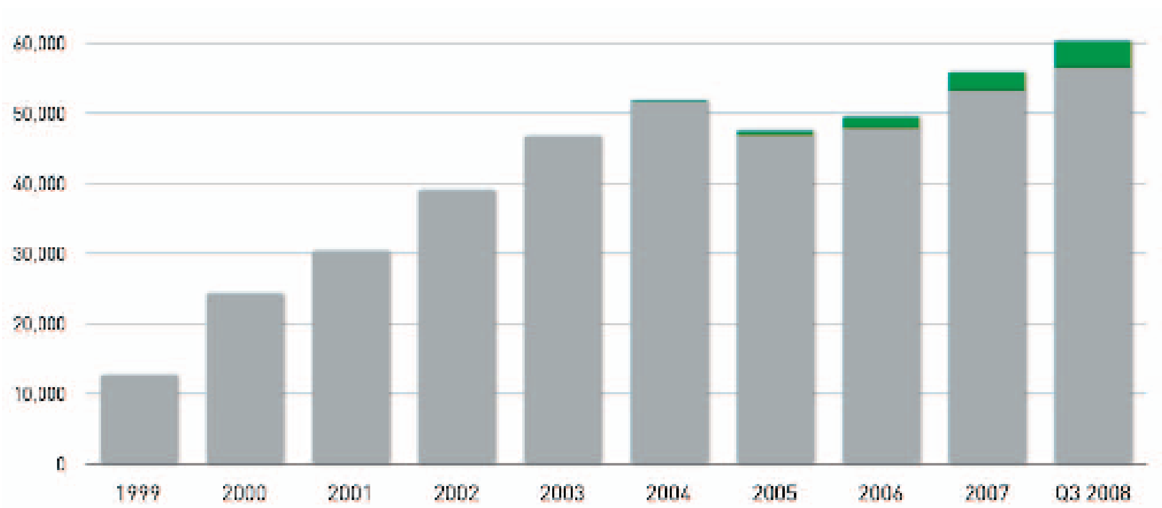
507/566 St Kilda Road, Melbourne 3004. Mailing Address: 72 Queens Avenue, Caulfield East Vic 3145
Email jjokane@aaashares.com.au Ph 9016 8989 Mob 0403 857 290 Fax 03 9525 8104
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230150) are Authorised Representatives of AAA Shares P/L (AFS 222138)

In June management forecast FLT turnover to increase another 10-15% in 2008/9 with similar earnings per share growth. At $16.00 per share FLT is priced at approximately 10 times earnings and has a dividend yield of 5.6% fully franked. Any slowdown in economic activity will merely delay the growth of FLT in the near term possibly effecting part of the business value - it will not stop it. Now consider this against our earlier review of value.

Infomedia (IFM)

IFM are the number two industry player with a 38% world market share in the provision of electronic parts catalogues (EPC) to the automotive industry with customers like Toyota and Ford dealers. When a car dealer needs to identify a car part for repair or replacement they use an EPC to identify that part quickly and correctly making the application critical to operations of their businesses. The better the EPC the more customers want to use it and via the feedback loop from the customers the more improved the product becomes making it more appealing to customers. Because of the critical nature of the EPC and low cost of use versus the car dealers overall cost of business operation the dealer tends not to be overly fussed by what they pay. More car models with more features makes the EPC even more critical. Hence profit margins are significant.

IFM's fortunes are linked to the number of subscribers who use their EPC i.e. they charge a monthly fee for use. Below is a chart of their subscriber history with the green (darker section) representing their new service menu product which allows car dealers to provide fixed quotes for car services which is proving critical for customer satisfaction. This product has the potential to match the EPC subscriber numbers.



While IFM has a fine record it has not been all smooth sailing which is the reason why the stock has been available at cheap prices for some time. In 2005 the business had to cope with its largest customer Ford Europe producing an internal EPC which resulted in 9,000 of the 18,000 dealers switching providers. The Ford product is cheaper but not better and that is why half have stayed with IFM. In the meantime Toyota started using IFM EPC and given they are the leading automotive manufacturer in the world that is a significant endorsement. The other headwind IFM has faced is the rising Australian dollar as most of its revenues are in USD or Euro's while its cost base is in Australia. The extended and extreme move in the currency has cost significant profits and hidden true growth.

[redacted]

Regardless of what happens to the economy the dependence of car dealers on EPC and eventually service menus will not decrease. This business has faced far greater individual headwinds than a shrinking economy. In fact the trend of uptake of IFM's products will continue to be higher because of the superior quality of its products as evidenced by Toyota's faith in the company. When the business cops an even break with the currency the real underlying growth that is occurring will become profit growth once again and the stock will be re-priced. In the meantime we have to put up with the no growth expectations of the market and live with the 80-90% payout ratio this company provides.

The company is currently buying back shares, has a net positive cash position and yes those dividend numbers are correct, over the last four years IFM has had the capacity to pay 29.5 cents of fully franked dividends against share price of what is now 36 cents. This stock is priced for not only no growth at 8 times earnings and on a yield of 10.5% fully franked but that it will be extinct. Absurd.

Harvey Norman (HVN)

We all know how HVN works. It is mainly a franchise operation in Australia creaming fees for advertising, stock lending, bulk buying, warehousing etc and collecting rent from company owned stores that are operated by franchisees who don't actually own the franchise. Secondly it operates regular retail operations in offshore places like New Zealand and Ireland using its knowledge to dominate weak competitors.

The franchise and company owned land/store model has made HVN the dominant retailer of all things it sells (e.g. it has 60% market share in retail sales of PC's) for the simple reason the guys running the individual stores are motivated to act like it is theirs and are consequently hard on selling and harder on costs yet when things in the retail world become difficult HVN is able to ease up on the rent expense keeping the stores competitive and gaining market share at the expense of competitors whose rent is fixed and get squeezed out. We have seen many recent examples of competitors selling out to HVN e.g. Megamart and Retravision NSW. When the economy is booming HVN gains earnings growth like everyone else and when the economy is difficult HVN gets the opportunity to purchase more land cheaply for future expansion and it takes market share from weakening competitors making HVN stronger. This gets to the heart of creating intrinsic value.

Earnings have proven a lot more stable than many people think but due to the complexities of the many facets of the business model it becomes difficult to work out what HVN could or should be making in profits. Hence the best advice I have heard to track HVN is to watch sales because you know Gerry Harvey is watching costs.

[redacted]

507/566 St Kilda Road, Melbourne 3004. Mailing Address: 72 Queens Avenue, Caulfield East Vic 3145
Email jjokane@aaashares.com.au Ph 9016 8989 Mob 0403 857 290 Fax 03 9525 8104
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230150) are Authorised Representatives of AAA Shares P/L (AFS 222138)

HVN is a business that would virtually be impossible to replicate (like Westfield) for close to its market capitalization and holds about $1.60 of property for each share that is worth $3.00. Consumer sentiment will always ebb and flow (consider the two year period around the GST for shocks) but sentiment towards larger TV screens won't. Any weakness in general retail sales and resulting profits presents an opportunity for HVN to strengthen its market position, it does not weaken it. As shareholders looking towards future growth we should be welcoming the opportunity. As shareholders' watching the stock price rise from $2.70 to over $7.00 and fall back to $3.00, it is difficult because it doesn't represent the facts of the situation, all it does is represent others' optimism and now pessimism. As shown earlier, any effect on profit that a slowdown causes only effects part of the total value of HVN, certainly not half the value.

<u>STW Communications (SGN)</u>

The sustained share price weakness of SGN is the most difficult occurrence in the portfolio to reconcile. Priced at $1.20 per share and with historic and forecast earnings of 21.5 cents and 22.5 cents per share respectively, SGN now trades on about 5.5 times earnings. The yield alone is 10% fully franked and that is after paying out only 55% of the earnings. A share price this low implies the business will suffer massive sustained earnings declines but a review of the facts and comments by management and competitors does not support this even if we suffer a recession.

SGN operates traditional advertising companies (who put together TV, news print and radio campaigns for clients) and fast developing specialist marketing/communication companies (digital media, web media, R&D, PR, Direct marketing etc). Within traditional advertising SGN owns 49% of J. Walter Thompson Group, 75% of The Brand Agency, 67% of BADJAR Ogilvy plus others and by being part owners of multiple competing advertising companies SGN benefits by being able to offer services to clients who compete, e.g. Westpac could be a client of J Walter Thompson and ANZ a client of BADJAR Ogilvy at the same time.

Originally the marketing and communication companies were brought into the SGN mix to service the needs of the advertising companies i.e. rather than outsource projects and have profit go outside the group. As forms of communication and entertainment (e.g. mobile phones, the internet, digital TV, radio, pay TV, video games etc) have evolved advertising markets have fragmented and traditional advertising companies have lost some their stranglehold over their clients and the marketing and communication companies have become much more important. SGN has risen to this challenge well with over 50% of profits coming from marketing and communication companies now. This segment of the market is growing at over 30% per annum and SGN has not been missing out, which has not only made up for the recent stagnant traditional advertising companies but places SGN well for future growth as this aspect of the business dominates traditional advertising.

[redacted]

507/566 St Kilda Road, Melbourne 3004. Mailing Address: 72 Queens Avenue, Caulfield East Vic 3145
Email jjokane@aaashares.com.au Ph 9016 8989 Mob 0403 857 290 Fax 03 9525 8104
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230150) are Authorised Representatives of AAA Shares P/L (AFS 222138)

SGN is not without a colourful history. John Singleton was a major player in developing the business along with Russell Tate. In fact Ogilvy from BADJAR Ogilvy (see above) used to be Singleton, Ogilvy & Mather Group. Adding further intrigue only a few years ago SGN owned a share in an Indonesian TV station. The market didn't appreciate this along with the complicated ownership structure that causes equity accounting requirements creating in turn transparency difficulties in statutory accounts. Management overcame this by providing in depth reporting they thought informative but the market has not appreciated the stock since the days 2001/02 when the stock traded on 30 times earnings (don't forget it is now 5.5 times earnings and makes twice the profit). Further causing market concern was Singleton's decision to cut his ownership position in 2007. Normally this would give cause for concern but he had just divorced wife number 5 (referred to as Chanel) and she was a divorce lawyer specialist. I guess he really did need the $50 million. No sooner had Singleton stepped out - Martin Sorrel stepped in, buying 19.9% of the company at around $2.80 to $3.20; the maximum he could without making a takeover. Sorrell is significant because he owns and runs WPP.

This is what Wikipedia has to say about Marin Sorrel:

He joined Saatchi & Saatchi in 1975, and was group finance director from 1977 until 1984. Often referred to as *"the third brother"*, he designed and carried out Saatchi's then legendary agency acquisitions. In 1985, Sorrell privately invested in Wire Plastic Products, a British wire shopping cart manufacturer, and joined it full-time as Chief Executive in 1986. He began to acquire "below-the-line" advertising-related companies, purchasing 18 in three years, including in 1987 when he stunned the agency world with a $566 million "hostile" takeover of J. Walter Thompson. Sorrell followed this in 1989 with another dramatic hostile $825 million buy of Ogilvy and Mather. WPP is regarded as the driving force for the period of consolidation which has been going on within the communications industry for the last ten to fifteen years. His WPP group has amassed the largest media buying group in the world, GroupM. Together with the giant creative agency networks, JWT and Ogilvy and Mather, WPP is one of the four major players in the global advertising market.

Sorrell hasn't shown his full hand yet and seems happy to let SGN buy back its shares as the price falls. Remember, every share purchased by SGN is one Sorrel wouldn't have to buy at higher prices when buying the whole company. From my reading of Sorrel, he gets what he wants, but hopefully not at our expense.

While the ownership changes should be noted, more important are the business operations. Much focus has been on an advertising downturn and this has not only seen SGN being sold off but other media players have been hit as well. For example TEN's share price is down from $3.80 to $1.40, and direct competitors Mitchell Communication are off from $1.25 to 47 cents and Photon from $7.00 to $2.70. What is difficult about SGN's share price sell-off is that SGN management have always maintained (even in boom advertising conditions) that SGN "is not impacted by cyclical swings in media spending and benefits from the proliferation of new media and channel opportunities" (this particular quote is lifted from the 2006 results presentation) because its revenue is not linked to the clients dollar advertising spend.

To complete the picture please be mindful that 2008's accounts will incur a one off unusual cost of $7 to $9 million as SGN consolidate their multitude of businesses in Sydney under one roof. Offsetting this cost are incentives from the new landlord but financial accounting doesn't provide and equal offset. This is well known to market participants and therefore because of its one off nature is inferred to be a balance sheet effect and not an operating item.

Management has recently confirmed the business should grow underlying earnings by 6 or 7% this year. SGN appears heavily oversold even on pessimistic expectations against a backdrop of a solid performing business.

507/566 St Kilda Road, Melbourne 3004. Mailing Address: 72 Queens Avenue, Caulfield East Vic 3145
Email jjokane@aaashares.com.au Ph 9016 8989 Mob 0403 857 290 Fax 03 9525 8104
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230150) are Authorised Representatives of AAA Shares P/L (AFS 222138)

BBC

Lastly I want to update on BBC. As mentioned in the half year report it has failed to live up to expectations as its share price has been dismal. Its current price does not reflect the underlying situation which explains why Lend Lease has just purchased over 7% of the stock after having attempted a takeover of BBC's other listed aged care competitor FKP Property Group. Along with the board who had initiated a review Lend Lease clearly thinks the price is too cheap. We need to wait this one out.

Hopefully these reviews give further insight as to why we own the stocks and why against falling share prices they remain required investments. On any valuation metric they all look significantly underpriced.

The mining sector

The emergence of China as the factory to the world and consumer of materials is probably one of the most important world developments contributing to GDP growth in recent years. Equally as important has been the emergence and our subsequent reliance on the internet and software applications, mainly because it affects almost every aspect of daily life and will continue to become even more important. This incorporation of the internet and software along with the emergence of China as a major world trading partner have added significant worldwide GDP growth by allowing for improved efficiencies and further gains in the law of comparative advantage – the very foundation of GDP growth.

Yet the emergence of significant influences on society does not mean there will automatically be enormous profits involved. Take a look at the chart below of the NASDAQ. The heralding of the internet age resulted in an asset bubble and we are almost a decade since the highs of the tech boom yet still less than 50% of the valuations of the boom.

So it is with China that asset price bubbles have been created. Witness their own stock market which is off 60% this year. Just because emergence of China is very important and appears to be happening fast doesn't mean profits will be plentiful forever for everybody.

Which brings me to one of the hardest aspects of 2007/8 - watching perfectly good businesses being sold off aggressively while others in the mining industry whose risk is very real push higher. Bear in mind the valuation process as we explore the situation in iron ore.

The circumstances in iron ore pretty much typify the story of the mining sector. Iron ore is used to make steel. You dig it up, crush it, smelt it and out comes steel. It takes about 85 million tons of iron ore from the Pilbara region to make about 50 million tons of steel in China. In 2001 iron ore sold for USD $28.90 a ton and in 2008 for over $132 a ton, amounting to a 460% price increase. Iron ore is known as a commodity because there is no shortage of it and the buyer doesn't care who it buys from.

Meanwhile, world production of steel has grown from 850 million tons in 2001 to 1,437 tons this year; a 69% increase. China is responsible for this growth having generated 150 million tons in 2001 to now produce 550 million tons in 2008. The year on year growth of Chinese steel production reads as follows: 2002 - 20.8%, 2003 - 22%, 2004 - 26.1%, 2005 - 26.8%, 2006 - 18.8%, 2007 - 15.7% and 2008 - 12%. Meanwhile the rest of the world has grown steel production at 3% per annum. Consider also that China's per capita steel consumption is now around that of the developed countries. China has now become an exporter of steel which indirectly means that China has reached a level of production saturation. Just to repeat, we have seen a 460% increase in iron ore prices on the back of world growth of 69% of which China is responsible and now its year on year production has well and truly peaked as has growth in its consumption levels. We also need to remember China is a communist country and not necessarily skilled on capital allocation based on sustainable profitability and they have allocated a lot of capital in the last few years.

507/566 St Kilda Road, Melbourne 3004. Mailing Address: 72 Queens Avenue, Caulfield East Vic 3145
Email jjokane@aaashares.com.au Ph 9016 8989 Mob 0403 857 290 Fax 03 9525 8104
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230150) are Authorised Representatives of AAA Shares P/L (AFS 222138)

A major beneficiary of the mining boom is obviously BHP. It has seen its business operating margins grow from 20% of sales to over 50% of sales due to commodity price escalation in recent years. With a shift in consensus opinion from a good commodity cycle to a stronger for longer super cycle to now an almost stronger for ever belief, you can imagine the justification in valuations. That, coupled with a positive view of the near future among the consensus, and you have share prices heading higher and/or holding up. But in reality this must be benchmarked against the facts of extended commodity prices, an increasing availability of supply, and increasing chances of shocks to the Chinese economy (China's terms of trade is deteriorating quite rapidly, inflation is strong and export growth has slowed to its lowest rate in the last five years – it could be zero by the end of the year). When these issues become consensus then there is a long way for prices to fall. It is very difficult to know how it plays out but the significant risk is to the downside.

The trouble with taking a long term view grounded in the basics of business economics is that we can look wrong for extended periods of time and in doing so look foolish. It has been four years (July 2004) since we last bought one of the four major banks and it has taken those four years to be proven correct about their prospects. But at the end of the day the basics of business economics were proven correct and the price came to reflect the long term growth prospects rather than excess credit growth consensus expectations. The mining sector will most likely prove to be no different as the only sure thing about China is they won't pay $132 a ton for iron forever.

<u>What has happened? 2007 is a lesson in history - A simple lesson simply not followed</u>

At the heart of today's financial troubles is a reasonably simple misunderstanding by market participants as to the worth of debt or financial leverage. The fact that the lesson is simple to learn does not make it easy to avoid. Buffett wasn't joking when he said debt is the dagger sticking out of the steering wheel of the investment vehicle you drive. When the brakes are slammed on….you get the picture what happens. Current deleveraging is being blamed for the asset sell downs around the world and subsequent banking write offs.

Operating leverage as compared to financial leverage is what makes a business highly valuable. The Holy Grail in business is the ability to sell more products to more people for more money while employing a fixed cost base and low amounts of capital. Add revenue to the top line in these businesses and most of it falls to the bottom line as profit. As long as the customer has to keep buying the product or service because it is: (1) needed or desired; (2) thought by its customers to have no close substitute; and (3) not subject to price regulation; then the earnings growth keeps coming courtesy of operating leverage.

Unfortunately businesses exhibiting these traits are difficult to establish in the first place, yet easy to identify when established and consequently rarely cheap to buy (now being an exception). Even more unfortunately for many investors the earnings profile of businesses with true operating leverage can be imitated for periods of time by businesses taking advantage of financial leverage. When debt is easy and assets are cheap then the incentive to buy up a lot of low quality assets and bank the difference between the cost of funding the debt and the return on these assets will replicate profit growth when repeated in larger and larger doses. By the time the music stops the market consensus hasn't been fussy enough to distinguish between the earnings growth of companies with operating leverage and financial leverage.

507/566 St Kilda Road, Melbourne 3004. Mailing Address: 72 Queens Avenue, Caulfield East Vic 3145
Email jjokane@aaashares.com.au Ph 9016 8989 Mob 0403 857 290 Fax 03 9525 8104
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230150) are Authorised Representatives of AAA Shares P/L (AFS 222138)

When past credit default rates have been low and therefore disguise true default risk the result is a strong willingness to lend money by the banks as they drop their lending standards to ensure they are part of the credit growth cycle. It always ends in an asset bubble. Even worse in the USA was the transformation of average and poor credit into higher grades of credit via credit enhancements. And investors bought it – it was a form of alchemy at best.

But we have seen the effects of leveraging and subsequent deleveraging before. Cast your thoughts back to the 1980's when Bond, Skase and the like went broke because they over paid for assets using huge amounts of debt that banks were only too pleased to lend. As interest rates went up and their positive gearing turned negative they couldn't fund the debt anymore and we had fire sales of assets. Fast forward to recent times and the exact same game has been played out by today's market participants like ABC Learning, Allco, Centro, other property trusts and many others. In the USA it has been played out slightly differently where they turned their hand to the science of alchemy by turning average and poor credit into high grades of credit and investors bought it. That hasn't worked either. Excessive use of debt was the error of the 1980's and so it has been now.

Lending institutions would be far better off if the economy grew at a boring 2% instead of strong 4%. In banking a strong credit cycle appears to be another way of saying short term profits and larger medium term losses. Australian banks are paying the price for all kinds of deleveraging at the moment but they will survive like they did last time.

There are very few similarities between the USA banking system and ours. Here the bank that sells the mortgage holds the mortgage and that provides an incentive to lend not only to get the interest but also the capital back because most of the funding comes from bank deposits. In the USA the likes of Fannie May, Freddie Mac and Gennie May (and they are the good operators with government endorsement) act as conduits between the borrower and eventual lender who never even sees the mortgage. In fact most USA mortgages are not what we have here, i.e. floating or three year fixed loans. They are long term fixed loans (e.g. 25 years) which the borrower may repay at anytime if rates drop, but is locked in if rates rise. The lender in the States gets a raw deal and it is no wonder every now and then the US housing market blows up – the incentives are there for it to happen.

The market and economy going forward

We can never hope to predict what and when will be the bottom (or top) of the market, as that depends on how extreme the last seller is and how far the earnings of the businesses drift from their long term averages and prospects. All that we can know is when stocks get really cheap, or get very expensive, compared to long term prospects.

The fact remains we now have an opportunity to purchase quality businesses at fair to good prices that we have not seen since 2003, regardless of how the next couple of years play out. There are too many conflicting indicators to be able to make a reasonable guess as to what happens in the short term. Employment remains high; there are skill shortages but inflation is also high; we have high interest rates and high oil prices - but are they at cyclical tops; there is a housing shortage and rents are going up - but housing prices are tipped to fall; and so goes the conflicting issues.

507/566 St Kilda Road, Melbourne 3004. Mailing Address: 72 Queens Avenue, Caulfield East Vic 3145
Email jjokane@aaashares.com.au Ph 9016 8989 Mob 0403 857 290 Fax 03 9525 8104
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230150) are Authorised Representatives of AAA Shares P/L (AFS 222138)

It is far more important to answer the question of *not when* **but if** earnings will be materially higher in the future. As I hold no long term concerns for Australia's prospects I want to hold businesses that service Australia and that are good enough to compete globally. Consensus opinions for no growth has meant Australian stocks are now on sale. The two best times to buy stocks are when:

1. Good businesses experience a hiccup that is specific to the business (i.e. not a structural industry issue) that can be resolved through management effort or time; and
2. When the market has significant falls and the good are thrown out with the bad.

If I can close on an upbeat note it would be the following information. When the market finally does bottom, market recoveries like the following have occurred in the past. Eventually prices will reflect underlying business economics and value will be recognised. Now is the time to invest more not less.

Oct/Nov 87	-49%
next 12 months	38%
Aug 89/Jan 91	-30%
next 12 months	42%
May 92/Nov 92	-20%
next 12 months	50%
Feb 94/Feb 95	-20%
next 12 months	20%
Mar 02/Mar 03	-24%
next 12 months	26%
Nov 07/Jul 08	-30%

As usual I want to leave the final word to Buffett which underlines the reason not to panic on any price moves associated with our stocks.

> "Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist. A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor to profit from them. If we can identify businesses similar to those we have purchased in the past, external surprises will have little effect on our long-term results."

Kind regards

Justin O'Kane
Portfolio Manager

507/566 St Kilda Road, Melbourne 3004. Mailing Address: 72 Queens Avenue, Caulfield East Vic 3145
Email jjokane@aaashares.com.au Ph 9016 8989 Mob 0403 857 290 Fax 03 9525 8104
Justin O'Kane (223620) and O'Kane Investment Services Pty Ltd (230150) are Authorised Representatives of AAA Shares P/L (AFS 222138)