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31 December 2010

Mr & Mrs Client

Dear Client

This year's half year report sets a new record – in timeliness. With the whole family leaving for Tasmania on the 2nd January I am pre-empting and writing before the year end so there is every chance this report has come in the mail with the Boxing Day/New Year sales catalogues. While feats of (positive) financial records are preferred, the last six months and for that matter the last 12 months, has not been anything to sneeze at. For example in the 2010 calendar year the stock market has ultimately finished flat but our portfolios are up.

Meanwhile this report deals with the first half of the 2010/2011 financial year being the period 1 July 2010 through 31 December 2010 where the market opened at 4301 and closed at 4745, for a gain of 10.3%. Add market dividends and franking credits and a portfolio 100% invested in stocks only would have returned approximately 12.8%, a portfolio invested 70% stocks and 30% income securities/cash a gain of 10.5% and a portfolio invested 50%/50% a gain of 9.0%.

The reason franking credits are reported in returns (clients and the market) is that for many clients franking credits are as good as cash and so should be measured. With the greatest majority of client accounts being super funds and a great percentage of those super funds in a pension phase attracting 0% tax, it means up to 100% of the franking credit are returned as cash to the client courtesy of an ATO refund (this deal makes the best off shore tax haven look like a rip off). Thus a 5% fully franked dividend is exactly equally to a 7.14% unfranked dividend and as such should be thought of and reported as the same. I have often joked I'm happy to be paid in franking credits.

Finally this letter contains the results for your portfolio(s) for the six month period beginning 1 July 2010 and ending 31 December 2010 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 an objective review and a position summary report (consolidated for multi account clients) with future dividend estimates.

Results for the 1st Half of 2010/11

Cash reconciliation

Closing E*Trade account balance on 31 December 2010	**$**	**-**
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	$	-
TOTAL net GAIN for the period	**$**	**-**

% change from the opening balance for the period

* contributions/withdrawls explained
less contributions of cash into E*Trade ANZ CMT $0
less contributions to E*Trade via stock $0
add back withdrawls of cash from E*Trade ANZ CMT $0
add back withdrawls via buybacks/takeovers with cash returned to you, $0

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

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Markets & Portfolios Reviewed

Equities Discussion

Without any new name stocks added to portfolios this half year, limited rebalancing and the market back to 4770 yet again, you would be forgiven for thinking nothing much has gone on recently. Such thoughts would belie the reality that has been occurring within the core holdings across portfolios. Within the broad economy much has been made of the re-emergence of key issues like the two and even three tier economy, issues relating to retailing, the level of the Aussie dollar, mining taxes and interest rate changes to name a few. While weighted portfolio returns for the last six months approximate the general market the underlying individual stock performances are a near perfect example of an average achieved by the extremes of sticking your head in the oven and your legs in the freezer.

Runaway stock prices for Flight Centre, ARB Corporation, Ramsey Health Care, Invocare and STW Communication have offset negative price movements from Harvey Norman and Billabong and lacklustre efforts from Westfield, Woolworths and Macquarie in the last six months. Only Platinum Asset Management and Cochlear hit market returns – not that I know what this implies. The market, as it always does in the short term, is rewarding businesses whose earnings have been and promise to continue increasing while playing a version of pass the parcel (each seller takes a bit off) on companies whose earnings appear soft. Across individual portfolios this divergence can cause some angst as stock movements eventually reflect weighted holdings outside what is normal for each account. This raises the question 'what to do now, let them run or trim them'? Finding an answer, which is never straight forward, is where considerable time and effort is spent.

It has been my thought for some time that the period we are going through is the financial equivalent of sorting the wheat from the chaff. Companies capable of executing superior strategies in pursuit of growth should in the current circumstances outperform those businesses with limited or no competitive advantages whom rely on favourable tail winds to produce more than just 'bob along' earnings. To a large extent this is what we are seeing play out, but a spanner (or two) has been thrown into the works regarding retail which is suffering at the hands of a more conservative consumer who has now incorporated the internet in their never ending pursuit of a better price. Add the continued high Australian dollar and strong mining conditions (probably the same thing) and it is having a distorting effect on the speed at which our companies are combating the competitive forces that shape profitability; for example the strong dollar is helping Flight Centres case but a hindrance to Billabongs situation. On a positive note none of these issues are in my opinion structural issues, be it industry or company specific. Rather they are timing concerns as currencies fluctuate and consumption by consumers and businesses ebb and flow.

Moving to the question about stocks for which the price has now run higher we need to consider how much price movement is justified by improvements in the underlying value i.e. intrinsic value and how much is just market sentiment that should be taken advantage of? Naturally this can only be answered stock by stock and leads to the next issue on pricing.

Finally, while these questions exist and there is always work and adjustments to be made within the portfolios I am generally satisfied that we hold appropriate positions given the risks and opportunities that the market currently presents.

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Our Investment Objective – Part II ‘A Rational Price’

“*Our Goal as investors should simply be to purchase at* <u>*a rational price*</u> *a part interest in an easily understandable business whose earnings are virtually certain to be materially higher 5, 10 & 20 years from now. Then, put together a portfolio of companies whose aggregate earnings march upwards over the years” Warren Buffett*

If you are getting a sense of de-ja-vu about the current stock market level (and these letters) then there is probably a good reason for your sensation. That is because in five of the last six calendar years (2007 missed) the Australian market (S&P200) has traded through the 4770 level in those years. With 2011 looming and the market again close to 4770 that run looks set to become six from seven.

As unusual as this occurrence is it is worth remembering that it hasn’t taken a precise market prediction of such a run to have profited during this period because we have seen a previous market high of 6850 and low of 3073. All that was required was to be aware at the extremes the market was stretched i.e. when it was bleatingly obvious.

But if we can’t rely on extreme market moves to throw up obvious opportunities then how do we progress? A graduation from relying on the obvious market extremes for signals to the improved standard of being more or less ‘roughly right’ must be made. Such a transition relates to pricing stocks and coincides with achieving an understanding of the missing link from our investment objective of what is “a rational price”.

In previous client letters I have set guidelines as to what I believe defines “an easily understandable business whose earnings are virtually certain to be materially higher 5, 10 & 20 years from now”. Consideration of what is a rational price for a stock, without first coming to grips of whether or not a business has a sustainable competitive advantage exploitable for many years ahead via the execution of an appropriate competitive strategy, is to make what is a difficult decision into an impossible decision. Hence all discussion as to a rational price is limited to businesses that meet the investment objective set out above. In other words businesses with insufficient degrees of certainty cannot be roughly priced let alone be rationally priced unless markets are at their extremes.

<u>Introduction to the Rule of 72.</u>

Before heading into a discussion on stock pricing, which involves a bit of mathematics, it is worth becoming familiar with the Rule of 72 as it offers a nice short cut in the pricing equation.

By dividing either an annualised percentage return or an amount of time into 72 we can estimate how many years it will take for the investment to double or alternatively what annualised return we need for our investment to double. For example if a 10% annual return on an investment is available then it will take approximately 7.2 years to double the original investment (72/10). Or if you want to double your investment in six years you will need to earn at an annualised rate of 12% (72/6). The result we get isn’t perfect but it is close enough to be useful.

<u>A Rational Price</u>

The starting point in determining a rational price for a stock is to establish a range of returns the investor requires for their money. For example an investor wanting a 10% annualised return is

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looking to double their money approximately every 7.2 years (72/10), a 12% annualised return is a 6 year (72/12) double and 14% return is a 4.8 year (72/14) doubling of investment.

Next step is to look for stocks that can meet those return expectations via a combination of dividend yield and earnings growth (resulting in justified capital appreciation). It doesn't matter what combination the dividend yield or growth comes in so long as the combined number meets the return expectation and, of course, that it occurs – hence our concentration on businesses likely to deliver. For example if an investor is looking to make a double on their investment every six years, then they need to average 12% per annum so a 10% yield (ignoring franking credits) plus 2% annualised earnings growth is as useful as a 2% yield and 10% earnings growth.

As mentioned there are two levers at play, the dividend yield and the earnings growth rate. The earnings growth rate we need to focus on is the long term sustainable growth rates which acts to smooth out cyclical earnings associated with businesses that deal with customer demands that ebb and flow. What is essential here is that the growth estimated must materialise over time not that it comes evenly, hence the concentration on those businesses with sustainable competitive advantages virtually certain to produce materially higher earnings 5, 10 & 20 years from now. Whatever growth rate is estimated it needs to be shown to be conservative and tested for reality.

We can test for both conservatism and reality in the long term growth rate estimate in two ways. First we can check a three way metric involving return on equity (ROE), payout ratio (P/O ratio) and implied growth rate for historic correctness. It makes sense that over time a company's future earnings growth rate represents the percentage return it makes on any capital invested multiplied by the amount of capital actually used – usually from retained profits. For example if it is estimated a company will grow earnings at 7% per annum through time and it pays out 60% of its earnings as dividends thus retaining 40% of earnings that are invested back into the business then it needs to generate 17.5% return on those funds to grow at 7% i.e. 17.5% (ROE) X 40% (retention ratio) = 7% earnings growth. The return on equity number can be compared to what has happened in the past to see if this is close to reality.

The second and more thorough test involves considering specifically what the anticipated growth rate implies need happen i.e. how and why will the business sell more goods and services to more people and for more money while containing costs and using an appropriate amount of capital in line with expectations. Remembering back to our Rule of 72 we know that 7% earnings growth implies the business needs to double its revenue and earnings etc in 10 years (72/7). So we set about understanding exactly what needs to happen. Obviously this is not an easy task so again the need to restrict any assessment to businesses for which there is a higher than normal hope of materialization.

The final step given a conservative and a realistic earnings growth expectation is to identify what dividend yield is needed to bring the combined return to the investors desired level. This is where the stock price comes into play. Assuming a stock that is anticipated to grow sustainably at 7% p.a. pays a $1 dividend then the investor requires a dividend yield (ignoring franking) equal to 5%. If they are looking for a 12% return or double in six years (72/12) they will happily pay $20 ($1/0.05) while an investor looking for less than a five year double wanting 14% per annum will need a 7% yield so would only pay $14.28 ($1/0.07). Therefore it is a combination of an investors required return, future earnings growth expectations and dividend yield that sets a rational price for a stock.

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Of course we can also reverse the process and back out the necessary growth rate having identified the current available yield and then decide if the growth is achievable. To run through an example, consider the situation with Harvey Norman (HVN) for which the market has become despondent. Based on current market prices HVN will yield approximately 4.7% this year. To meet a 12% or six year investment double from HVN's current price level an investor requires HVN over time to grow at an average of 7.3% (12% - 4.7%) or double its earnings over the next ten years (72/7.3). HVN currently and historically has paid out an average of 50% of its earnings as dividends thus retaining 50% and has a long term return on equity of 15%. Using test one we can see that 7% earnings growth for HVN is not unfeasible i.e. 15% (ROE) X 50% (retention ratio) = 7.5% (needed growth rate). The second more difficult test involves understanding how those earnings will double over the next ten years. For HVN a doubling of earnings requires 2021 earnings per share (EPS) of near 50 cents per share and dividends of 26-28 cents per share from today's estimate of EPS of 25 cents and dividends of 13-14 cents. If one considers future GDP growth, inflation, normalised housing starts, continued immigration, end of Irish losses (worth 5 cents per share alone) etc it isn't hard to envisage getting close to 5% or 6% earnings growth. Further consider that current earnings are depressed and that HVN will have further organic growth as future competitors stumble (Mega Mart, Retravision NSW, Clive Peters) and a 7.3% averaged growth rate isn't that far off – in fact it may prove undemanding as its superior business model out competes current threats and future competitors.

Or consider Woolworths who have a forecast 4.8% dividend and therefore require a long term 7.2% earnings growth to provide an investor with a six year investment double i.e. 12% annualised return. Between organic growth, GDP growth, inflation and expansion plans a combined 7% earnings growth seems undemanding for Woolworths. WOW pays out 70% of earnings as dividends so to grow at 7% needs a return of equity of 23% which is below their long term historical average of 27%, i.e. it is realistic.

The simplification of the above examples gloss over the need for the companies to work tirelessly in such areas as market share, manufacturing, distribution, product innovation, changing market conditions etc but those considerations and others are dealt with before a company even gets to the pricing stage. Remember a company has to be capable before it is priced. If someone is then happy with the equation that the current price presents then the price supporting the dividend component is a rational price to pay.

What is interesting about this price process is that it pays no attention to the price to earnings ratio (P/E or PER) as a measure of opportunity or value. That is because earnings are only important to the extent they can be paid out as dividends or successfully reinvested at high rates of return. Consider a business paying out 80% of its $1.25 earnings for a $1 dividend and another paying out 20% of its $5 earnings for a $1 dividend, who both have identical long term earning growth prospects of 7%. Based on a 12% desired investment return both businesses are worth $20 ($1/0.05) to the investor but the first business has a P/E worth 16 ($20/$1.25) to the investor and the second a P/E worth 4 ($20/$5) to the investor. The reason for the P/E discrepancy lies in the return on equity capability of the two businesses, the first having an ROE of 35% and the second a ROE of 8.75%. If you see someone justifying a stock as either cheap or expensive based on a P/E without reference to the payout ratio and return on equity you are most likely seeing someone who themselves is unsure of what is a rational price.

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While this process is a simplified description of a rational pricing process it contains the framework of what is important. Caveats obviously apply with regard to the stability of the current earnings/dividend situation, normalised profit margins, allowances for lower growth rates offset by higher dividends etc but all the essentials are there.

What is important is that I now incorporate the above thinking into my investment process when it comes to price and have consequently moved a step closer to being able to be roughly right more often rather than relying on only obvious signals. Never fear of me taking this any further in the pursuit of trying to become more than roughly right at the expense of being precisely wrong. As the last step on the ladder recommends; Danger – do not go above this step, you may lose your balance.

Finally a word from Buffett

Also included within this letter is a message from Warren E. Buffett entitled 'What You Should Know about the Jewelry Business' and what I describe as a five minute MBA in retailing. It is a nice insight into the economics of any retail business.

I would like to take this opportunity to thank those clients who upon reading the last edition of this letter gave consideration to providing support and I would also like to welcome all new clients as a result of that support.

Finally I wish everyone the best for the festive season and if you are travelling for holidays that it is both a safe and enjoyable break.

Yours sincerely

Justin J O'Kane, CFA

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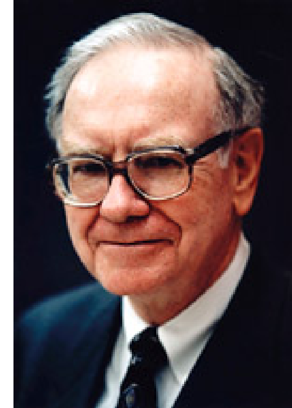
A Message from Warren E. Buffett
Chairman, Berkshire Hathaway Inc.

What You Should Know About the Jewelry Business



You don't need to understand the economics of a generating plant in order to intelligently buy electricity. If your neighbor is an expert on that subject and you are a neophyte, your electric rates will be identical.

But jewelry purchases are different. What you pay for an item vs. what your neighbor pays for a comparable item can be, and often is, widely different. Understanding the economics of the business will tell you why.

To begin with, all jewelers turn their inventory very slowly, and that ties up a lot of capital. A once-a-year turn is par for the course. The reason is simple: People buy jewelry infrequently, and when they do, they are making both a major and very individual purchase. Therefore, they want to view a wide selection of pieces before zeroing in on a single item.

Given that their turnover is low, a jeweler must obtain a relatively wide profit margin on sales in order to achieve even a mediocre return on their investment. In this respect, the jewelry business is just the opposite of the grocery business, in which rapid turnover of inventory allows good returns on investment though profit margins are low.

In order to establish a selling price for their merchandise, a jeweler must add to the price they pay for that merchandise, both their operating costs and desired profit margin. Operating costs seldom run less than 40% of sales and often exceed that level. This fact requires most jewelers to price their merchandise at double its cost to them or even more. The math is simple: Jewelers charge $1 for merchandise that has cost them 50 cents. Then, from their gross profit of 50 cents they typically pay 40 cents for operating costs, which leaves 10 cents of pre-tax earnings for every $1 of sales. Taking into account the massive investment in inventory, the 10-cent profit is adequate but far from exciting.

At Borsheim's the equation is far different from what I have just described. Because of our single location and the huge volume we generate, our operating expense ratio is usually around 20% of sales. As a percentage of sales, our rent costs alone are fully five points below those of our typical competitor. Therefore, we can, and do, price our goods far below the prices charged by other jewelers. In fact, if they priced to match us, they would operate at very substantial losses. Moreover, in a virtuous circle, our low prices generate ever increasing sales, further driving down our expense ratio, which allows us to reduce prices still more.

How much difference does our cost advantage make? It varies by competitor but, by my calculation, what costs you $1,000 at Borsheim's will, on average, cost you about $1,350 elsewhere. This is called the “Borsheim’s Price”. There are very few instances where we are unable to offer you those great savings due to restrictions, but you will always know upfront if an item is non-discountable.

Of course, price means nothing unless you are sure of the quality of what you are getting. When products are branded, such as watches and chinaware are, comparisons are simple. But jewelry is usually a "blind" item - and that puts virtually all purchasers at the mercy of the seller.

I can remember well how helpless I used to feel in a Fifth Avenue or Rodeo Drive jewelry store, where the only thing I knew for sure was that the operator had extraordinarily high overhead - and that they had to cover it in their sales price. I was also wary of the "upstairs" solo operator who operated on consignment merchandise, since that would have cost them more than merchandise bought outright, and would necessarily have inflated their retail price. And, finally, I always worried about the quality of what I was getting I couldn't tell the difference between an emerald or a diamond worth $10,000 and one whose value was $100,000. (I still can't.)

My sense of helplessness led me to an obvious conclusion: "If you don't know jewelry, know your jeweler." For that reason, I made all of my jewelry purchases at Borsheim's for many years before Berkshire Hathaway bought the company. I didn't know stones, but I did know Ike Friedman, the retailing genius who had built the business from nothing into one of the nation’s largest independent jewelry stores. When I purchased Ike's business, I did it without

an audit but with full confidence that I was getting value received. And that's just what I got - precisely as I had when I purchased a single piece of jewelry from him.

The main point of this letter is to tell you that you don't have to live near Omaha to benefit from Borsheim's. Our "shop-at-home" program brings Borsheim's to our qualified customers. Simply contact Borsheim's to describe what you're looking for – to any degree of detail. We will assemble selections that best reflect your wishes and send them to you. Then, in the comfort of your own home or office, you can conveniently and leisurely select the item(s) you most prefer, or return the entire selection.

Our results from this "shop-at-home" program have been amazing. Customers have loved it and keep coming back for more. Each year, we send out several thousand packages, ranging in value from $100 to $500,000. Call us at 800-642-GIFT (4438) to learn how to qualify for Borsheim's "shop-at-home" program.

At Borsheim's the service will be exemplary, the price will be exceptional and the merchandise will always be what you are told that it is. You have my word.

Warren E. Buffett
Chairman of the Board

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