



In this quarterly edition we review performance and attribution. We introduce OzForex an IPO. We discuss deflation, economists and New Zealand. At home we take a look at Five super sectors, HECS and provide other business snippets. Photo: Deflation.

About Selector

We are a boutique fund manager and we have a combined experience of over 150 years. We believe in long term wealth creation and building lasting relationships with our investors.

Our focus is stock selection. Our funds are high conviction, concentrated and index unaware. As a result we have low turnover and produce tax effective returns.

First we identify the best business franchises with the best management teams. Then we focus on valuations.

Our fund is open to new subscriptions. Please forward to us contact details if you would like future newsletters to be emailed to family, friends or business colleagues.

Dear Investor,

When we entered 2013, very few expected the year to be as positive for investors as the records now duly show. Locally, our market advanced 19.7%, having had a mixed first six months before finishing strongly in the back half. Offshore, the news was even better with the US market climbing its own "wall of worry" to notch a 26.5% gain for the year and in the process setting a new record high for the Dow Jones Industrial Average of 16,576.66 points. So with such a positive year behind us, what can investors expect of 2014?

In short, we should continue to expect the unexpected. Anchoring one's views to a particular outcome is not a strategy we recommend because it has a nasty habit of biting you when you least expect it. The global macroeconomic forces currently at play have investors on edge. In the US, the implications of the Federal Reserve turning off the liquidity tap dominates discussions. Closer to home, a clearly slowing economy and one caught in transition is threatening to stall.

And yet the property and share markets are all pointing up in a sign that confidence is emerging. Low interest rates have given businesses some respite and encouraged consumers to spend but the world is clearly still struggling with the aftermath of the financial crisis.

With that as a backdrop we make the following observations. The US recovery remains on track although don't expect a smooth ride. While interest rates are set to rise from a current near zero setting, they will remain at historically low levels for some considerable period of time, thereby providing sufficient incentive for businesses to invest. The housing market, so important in stimulating economic activity is clearly trending up and new company listings are now taking place both here and abroad.

Locally we have a series of issues to overcome. A lower dollar will certainly help matters but it isn't the panacea to all our problems. Government infrastructure spending and a stronger housing market will go some way to address the current imbalance between mining and non-mining related activity. However, we suspect that many locally based businesses will struggle over the course of 2014, as top line growth becomes difficult to achieve.

In this quarterly report we comment on portfolio performance and review newly listed business OzForex. We include comments on the improving US budget deficit position, the role of economists, Australia's five super sectors, which unsurprisingly, do not include car manufacturers, snippets on some listed businesses and a final word on our near neighbours New Zealand.

During the past quarter and over the course of 2013 the Fund delivered a gross positive return of **3.6%** and **32.3%** respectively as compared to the All Ordinaries Accumulation Index which returned **3.42%** and **19.7%** in comparison. To all our investors we trust that you find the report informative and extend our best wishes for the year ahead.

Regards
Tony Scenna
Corey Vincent
Robert Lapsley

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Quote: Janet Yellen

US Federal Reserve incoming Chairwoman giving her views on the US economy in 2009

"I'm going to put my cards on the table right away. I think the predominant risk is that inflation will be too low, not too high, over the next several years. If the economy fails to recover soon, it is conceivable that this very low inflation could turn into outright deflation. Worse still, it is conceivable that if deflation were to intensify, we could find ourselves in a devastating spiral in which prices fall in an even faster pace and economic activity sinks more and more."

Performance December 2013

For the quarter ending December 2013, the Fund delivered a gross positive return of **3.61%** as compared with the **3.42%** rise in the All Ordinaries Accumulation Index. Performance statistics are detailed on page 22.

Performance table since inception

% Returns	Gross Fund Return	All Ords Index	All Ords Acc Index
3 months	3.61%	2.59%	3.42%
1 Year	32.33%	14.76%	19.66%
3 years	13.81%	3.37%	7.99%
5 years	19.34%	7.91%	12.67%
Since inception compound p.a.	11.01%	3.85%	8.32%

Top 10 December 2013*	Top 10 September 2013*
Aristocrat	Aristocrat
CSL	Computershare
Flight Centre	CSL
21 st Century Fox	Flight Centre
IOOF Holdings	21 st Century Fox
IRESS	IOOF Holdings
NIB Holdings	IRESS
ResMed	ResMed
SEEK	SEEK
Sirtex Medical	Sirtex Medical
Top 10 = 53.69%	Top 10 = 61.19%

*Listed in alphabetical order

Selector runs a high conviction, index unaware, stock selection investment strategy with typically targets 15-25 stocks chosen for the Fund. As shown above, the Fund's top 10 positions usually represent the majority of its equity exposure. Current and past portfolio composition has historically been very unlike that of your average "run-of-the-mill index hugging" fund manager. Our goal remains to focus on truly differentiated broad cap stock selection rather than the closet index hugging portfolios offered by most large fund managers.

Performance attribution for the quarter

Top 5 stock contributors	%	Top 5 stock detractors	%
NIB Holdings	+0.78	Sirtex Medical	-0.98
SEEK	+0.77	WorleyParsons	-0.77
OzForex	+0.72	ResMed	-0.52
Domino's Pizza	+0.66	Carsales.com	-0.30
Computershare	+0.52	Flight Centre	-0.29

During the quarter, the Fund performed in line with the general market, posting a gross gain of **3.61%**. For the 2013 calendar year, an exceptionally strong result from the portfolio of holdings saw the Fund record a rise of **32.33%**, well in excess of the market's gain of **19.66%** (inclusive of dividends). Below we provide a snapshot of index performances from a number of countries. Over the past year, the Japanese market has been the stand out market over both the one and five year periods, however, these returns purely reflect a point in time. The US market has also done exceedingly well and as we comment further in our report, the New Zealand market has performed better than our local market over both periods.

Country share market performances over one and five years

Country	Index	1 Year Return Dec 2013	5 Year Return since Dec 2008
Japan	Nikkei 225	56.7%	83.9%
US	Dow Jones	26.5%	88.9%
Germany	Dax	25.5%	98.6%
Spain	IBEX 35	21.4%	7.8%
France	CAC 40	18.0%	33.5%
New Zealand	NZX 50	17.0%	75.6%
Australia	All Ordinaries	14.8%	46.3%
Britain	FTSE 100	14.4%	53.4%
China	Shanghai Composite	-6.8%	16.2%

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For the quarter, strong contributions were posted by health insurer NIB Holdings and online employment group SEEK following an investor update on upcoming asset sales and positive company performance. As we highlighted in our September 2013 newsletter, the Domino's Pizza business continues to attract investor interest as noted by the good share performance to date. Whilst we acknowledge that the group's valuation is high, we are prepared to give this business and management team some leeway particularly as it enters the Japanese market. Newly listed money transfer operator OzForex, is profiled in this report and provided a solid contribution for the period as did global share registry group Computershare.

A number of businesses impacted the Fund's performance for the period including, cancer therapy group Sirtex Medical, engineering services provider WorleyParsons following an earnings downgrade, online automotive group Carsales.com and sleep apnea manufacturer ResMed. Flight Centre's recent court lose following action taken by the ACCC weighed on performance and may continue to impact its share price until a final penalty is handed down, now expected 27 February 2014. **SFM**

OzForex Group: (ASX OFX)

At a time when many companies are re-entering the public arena and private equity owners are looking to cash out, one business that caught our eye is international money transfer operator the OzForex Group. Below we provide a snapshot of why this business may just live up to the hype that surrounded its listing.

Table 1: OzForex Group: company history 1998 - 2013

Year	Events
1998	Business founded by Matthew Gilmour, launching foreign exchange information website OzForex.
2001	NZForex brand launched.
2003	Australian Financial Services License granted Company begins offering international payment services.
2005	London office opened UKForex brand launched.
2007	Macquarie Bank becomes 51% shareholder in group First payment solution established with Macquarie.
2007	Annual international payments transaction turnover exceeded \$1 billion.
2009	Establishes international payment solution with ING Direct.
2010	Private equity groups Accel Partners and Carlyle Group take 22.7% and 20.4% interest in OzForex.
2010	Macquarie Bank reduces holding in OzForex to 19.9%.
2011	Annual international payments transactions exceeded \$7 billion Hong Kong office opens Clear FX brand launched.
2012	OzForex Travel Card launched.
2012	USForex brand launched.
2012	Establishes international payments solution with Travelex in UK.
2013	Establishes international payment solutions with MoneyGram in Australia and New Zealand.
2013	Establishes international payment solutions with Travelex in Australia and New Zealand.
2013	October - OzForex lists on stock exchange total shares on issue 240M issue price \$2.00 enterprise valuation \$451M.
2013	Private equity owners sell out founding shareholders Lord and Gilmour each retain 4% position in company.

Table 2: OzForex financial summary

Year	Mar 2011	Mar 2012	Mar 2013	HY Sep 2013 (a)	Mar 2014 (f)*
Transaction turnover (\$bn)	7.0	7.4	9.1	6.6	12.6
Net fees and commission (\$m)	35.0	39.6	50.3	34.3	66.9
Interest income (\$m)	2.0	2.1	1.8	0.8	1.4
Revenue (\$m)	37.0	41.7	52.1	35.1	68.3
Employee costs (\$m)	(10.2)	(12.5)	(16.7)	(12.9)	(23.3)
Promotional costs (\$m)	(3.0)	(5.1)	(6.8)	(5.3)	(9.6)
Occupancy costs (\$m)	(0.70)	(0.70)	(1.2)	(0.7)	(1.5)
other costs (\$m)	(3.7)	(4.3)	(2.70)	(3.0)	(6.7)
Depreciation(\$m)	(0.4)	(0.5)	(0.5)	(0.3)	(0.6)
Total Expenses (\$m)	(18.0)	(23.1)	(27.9)	(21.9)	(41.7)
Profit before tax (\$m)	19.0	18.6	24.2	12.9	26.6
Tax (\$m)	(5.8)	(5.5)	(7.1)	(3.4)	(8.0)
Net Profit (\$m)	13.2	13.1	17.1	9.5	18.6
Earnings per share (cents)	5.5	5.5	7.1	4.0	7.8
Other data points					
Active clients (000's)	61	76	92	107	123
Transactions (000's)	314	388	460	285	611
Average transaction size (\$)	22,293	19,072	19,783	23,100	20,622
Average cost per registration (\$)	42.4	58.8	63.8	70.7	67.6
Average commission per transaction value (%)	0.50	0.54	0.55	0.52	0.53

* Prospectus numbers from company documents

Business background

As a business OzForex is classified as a Money Services Bureau (MSB), which is effectively a non-bank provider of currency services. The group operates a very simple business model - to provide consumers and business owners with an online international payment services platform, enabling foreign exchange payments from one bank account to another, in over 50 currencies, at a fraction of the price that a Money Services Bureau charges. In this context, some investors may misconstrue a simple business as vulnerable to competitive attack. To the contrary, while the offering appears simple, the business model supporting its service offering is both comprehensive and seamless from the perspective of the customer.

The business was founded by Matthew Gilmour, who in 1998 established an information only foreign exchange website. Reflecting back on the move, Gilmour stated;

“The idea for OzForex came about by applying what was going on in financial services at the time – which was the rise and rise of the non-banks, in areas such as mortgages, combined with the obvious power of the internet to the very old business of foreign exchange.”

In 2003 the group was granted its own Australian Financial Services License, opening up international payment services directly to clients. Today, the firm’s operations have expanded from Australia to include the United Kingdom, Canada, the United States and a number of countries in Europe. During 2013, OzForex completed over 460,000 international payment transactions valued at over \$9.1 billion, earning the group \$17.1 million in profits.

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In 2008, Gilmour offered some insight on the group’s success thus far;

“At OzForex we regard ourselves as an IT firm first, and a financial services firm second. In the last decade the IT focus has allowed us to grow quickly and consistently whilst managing risk very tightly. Our key principles in OzForex mean we pride ourselves on being very transparent with our fees and rates to clients and we try to embed excellence in everything we do but especially in relation to the client experience and our systems.”

OzForex business model

OzForex generates income by charging a percentage on each transaction undertaken and a fixed fee where amounts are small. OzForex classifies its customers as either consumer or business. Consumer customers include high net worth individuals, expatriates, international travelers and students. During 2013 the average transaction value was about \$14,300 and new customers typically undertake seven transactions within three years of setting up an account. Historically the consumer segment has generated some 67% of group income.

In contrast, business customers include small to medium sized enterprises and larger organisations. These clients have on average, transferred funds valued at \$29,000, while undertaking some 39 transactions during the initial three years.

When a transaction is undertaken, pricing is automatically generated by an algorithm, taking into account the specific currencies involved. OzForex charge a spread that has averaged 60 basis points (0.60%), whereas banks typically charged anywhere from 2% -5% offering little transparency. On an average consumer transfer of

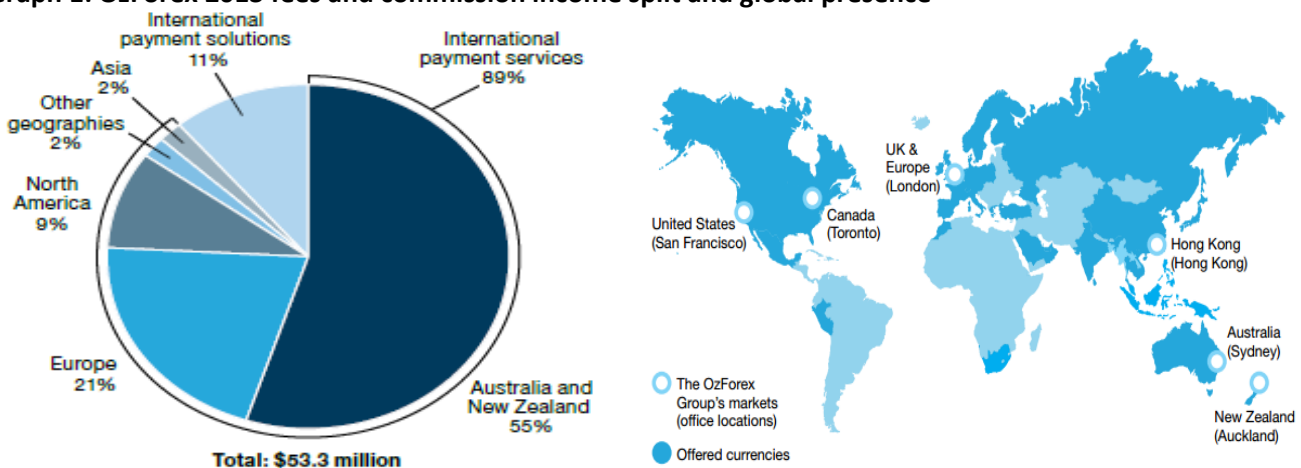
\$14,300, this would see OzForex’s earning a spread of \$72, thereby netting the client \$14,228. In contrast, under the typical bank transfer model, a client would typically incur costs ranging from \$286 - \$715 to complete the transfer.

The OzForex offering disrupts the Money Services Bureau business model. Its online offering is both scalable and technology friendly, allowing both consumers and businesses to participate in its offering. As **Table 2** highlights, the revenues OzForex generates are a function of the turnover transacted. During 2013 this resulted in revenues of \$50.3 million on a total transaction value of \$9.1 billion.

OzForex operations

The group is a global provider of international payment services that employs 170 staff and has in place relationships with 12 major banks, providing a network of accounts with 115 local banks that are used to both receive funds from clients and make payments directly to beneficiaries’ accounts. This networking reduces the reliance on the international banking network, allowing OzForex to compete effectively thereby creating a significant barrier to entry. **Graph 1** highlights the composition of fees earned and OzForex’s global presence.

Graph 1: OzForex 2013 fees and commission income split and global presence



* OzForex 2013 prospectus

The market

Apart from the regulatory issues required to operate a Money Service Bureau business, the biggest hurdle has been gaining access to the banking network necessary to execute the transfer of funds. Historically this has been the domain of major banks, money transfer organisations and other international payment specialists. The list includes our major banks, and offshore operators such as Western Union, HiFx, World First, Cambridge Mercantile and Xoom.

Where OzForex has successfully executed thus far has been in its ability to provide an ultra-competitive service offering that can be applied consistently and with transparency, underpinned by high touch customer service utilising the benefits of online technology.

Locally, OzForex has grabbed a significant foothold in the foreign exchange payments market, with a market share estimated at 5%, leaving other non-bank players with a collective 5% share and the major trading banks holding the balance.

Having secured its beach head in Australia, management is extending its offering both here and abroad, as it increases its marketing efforts, expanding into new regions and furthers its partnership offering. The market opportunity is significant albeit difficult to quantify as there is no centrally cleared market for international payments. The World Bank provides some insight, with data showing global remittance volumes between consumers and corporate clients having grown at a compound rate of 13% for the past decade, to a figure of approximately US\$600 billion. In this context, the online payment channel has growing influence, currently sitting at 16%, while the cash to cash channel makes up the bulk at 48%.

Business operations

OzForex operates seven websites and manages another four branded international payment solution websites on behalf of its partners. Operating a highly scalable, technology driven business, the group's main direct expenses are tied to hedging and transaction banking costs, while operating expenses are primarily employee costs, technology investment and promotional costs associated with acquiring new customers.

Table 3: Geographic income contribution

\$m	FY11	FY12	FY13	HY14(a)	FY14(f)*
Australia & NZ	22.1	24.7	29.5	19.9	38.4
Europe	7.4	8.7	11.4	7.5	13.8
North America	3.0	3.4	4.8	4.0	8.8
Asia	0.6	.6	0.8	0.7	1.3
Other	0.5	.6	0.9	0.7	1.3
International payment solutions	5.4	4.6	5.9	4.3	9.1
Income before hedging & transaction costs	39.0	42.6	53.3	37.2	72.7
Australia & NZ percentage of total income	57.0%	58%	55%	52%	53%

* Prospectus numbers from company documents

As **Table 3** illustrates, OzForex's move into international markets is at an early stage. While local operations have naturally dominated total group commission income to date, the progressive move into the US market supported by new international partnership agreements is reflected in a growing offshore contribution. Importantly, OzForex is now licensed to operate in 30 US states including the important New York market, with a further 7 states pending approval. Management expects North American commission income to rise from \$4.8 million in 2013 to \$8.8 million in the current year.

The International Payment Solution division houses the group's branded business operations with partnerships including MoneyGram and Travelex. As the table above depicts, this area is also expected to show rapid growth, indicated by the 2014 forecast growth in commission income from the \$5.9 million to \$9.1 million.

What are branded partnerships?

Through this offering OzForex provides partner companies with online and mobile application solutions that integrates the group's technology into the relevant partner's website. The website carries the partner's brand name, however, all transactions are handled by OzForex. In the industry this is referred to as a "white label"

arrangement, which allows the group to source new business with minimal additional investment. Under this model, OzForex pays a percentage of the revenue earned to its partners while leaving the majority of marketing costs to them.

While we are loathe to describe the company's online offering as unique, partnerships with a number of major international players provide important validation for the group. In all, OzForex operates four branded partnerships, including Macquarie Bank as preferred supplier, extending out to 2022, ING Direct in Australia expiring 2016 and more recently internationally recognised operators Travelex and MoneyGram out to 2018.

Of these, we can single out MoneyGram, a US\$1.0 billion Nasdaq listed payment provider, who in 2012 generated turnover of US\$1.3 billion and operating income of US\$180 million. This agreement sees OzForex undertake transactions on behalf of MoneyGram clients for all Australian and New Zealand transfers.

A perhaps more important partnership was established with privately owned, UK based operator Travelex. This deal was first struck in 2012 for the UK market. In 2013, this arrangement was extended to the Australian and New Zealand markets under an exclusive global deal to provide Travelex with a branded online service. In November, CEO Helm noted during the company's first results briefing that the Travelex partnership would look to go live in the North American market by March 2014.

The importance of these agreements not only reflects confidence in the OzForex online offering but also provides the company access to existing client bases that can be readily marketed to. It's early days but such endorsements are hard to ignore and we expect more partnerships as the shift online gains traction.

Business risk

If we were to name the key risks to the business, competitive price responses from the major trading banks and the emergence of new entrants in the Money Services Bureau space would rank high. To this list we would also add reputation, operation and execution as other areas of risk.

That said, in our opinion the company's biggest business risk surrounds OzForex's continuing ability to tap into the network of local and global accounts to complete money transfers that are reliant upon arrangements with a number of external banks. In aggregate, the group has arrangements with seven banks that provide counter party services. OzForex has relied heavily on Barclays Bank, who act as the group's primary counter party bank for about 64% of turnover, although this is down from 73% in 2010. The remaining partner banks include Bank of America, BNY Mellon, Credit Suisse, Macquarie, UBS and Westpac.

In recent times, a number of the larger banks have either scaled back or ceased providing counter party services to Money Service Bureau's following the discovery of fraudulent money laundering activities by some operators. In some ways this is a double edged sword, presenting a high barrier to those wishing to enter the industry but also exposing OzForex should the counter party offerings, which the group so heavily relies upon, be altered or worse still, removed.

Compliance

Macquarie Bank's involvement as a major shareholder from 2007 assisted OzForex with the development of an operational risk and compliance framework that is now embedded into the group's operating platform. This earlier investment now has the group well positioned to meet the comprehensive compliance requirements covering multiple license regions, as evidenced by the company's successful expansion into the US market. The group itself does not speculate on currency movements, rather, when the transaction is booked, the exchange rate is determined and funds are subsequently moved 24 hours later. Any exposure to rate moves are limited, with the group typically utilizing the services of the counter party banks once individual net currency exposures in aggregate hit certain levels, typically \$250,000 in value. At this point, the exposure is covered with one of the counter party banks, a scenario that on average plays out once every 8 minutes.

Financials

Table 2 provides a snapshot of the group's earnings profile since 2011. The group's simple operating model is replicated in the financial accounts, where the transaction turnover line reflects the combined gross dollars transferred and where the revenue line captures the commissions OzForex generates. In essence, the group's various activities derive an average commission of 0.60% per transacted amount.

Costs are relatively straight forward, with employee costs and promotional marketing making up the bulk of expenses. Importantly for online operators, the skill is in attracting new clients while keeping a lid on the costs. Since 2011, the group's acquisition cost per new client registration has lifted from \$42.40 to \$63.80. In isolation, the number appears to be heading in the wrong direction, however, this is countered by the average transaction size and commission percentage earned, showing a positive upward trend.

Marketing

During 2013, 97% of the group's new clients were acquired of which, whereby 55% were generated from paid marketing channels such as Google and Facebook while the balance resulted from unpaid channels, typically word of mouth and partner referrals. In 2012 the group launched a free mobile app for iPhones and Android smart phones, enabling users to check foreign exchange rates. Currently the mobile app is driving about 10% of all visits to the group's website, hitting a record 275,000 for the month of June.

Table 4: Margins

\$m	FY11	FY12	FY13	HY14(a)	FY14(f)*
Net operating income (\$m)	35.0	39.6	50.3	34.3	66.9
EBITDA (\$m)	17.4	17.0	22.6	12.4	25.8
EBIT (\$m)	17.0	16.5	19.5	12.1	25.2
NPAT (\$m)	13.2	13.1	16.8	9.5	18.6
EBITDA margin (%)	49.7	42.9	45.2	36.1	38.5
EBIT (%)	48.5	41.7	39.0	35.3	37.8
NPAT (%)	37.7	33.0	33.6	27.8	27.8

Not surprisingly, the online Money Services Bureau model attracts plenty of attention, evident in the margins that are being generated. At both the operating and net profit margin levels, OzForex earns in excess of 20%, as

minimal capital spend is required, as the business holds no inventory and client payments are made upfront before any transfers are made. As such, cash flow generation is strong and is a key feature of the business.

Balance sheet

In keeping with the business model, the balance sheet is clean and relatively simple in nature, with the biggest asset item, cash and the largest liability, reflected in payables to clients. At September 2013, OzForex held \$127 million in cash, offset by \$94.9 million in payables, leaving the group with net cash of \$32.2 million. Net equity stood at \$30.5 million, underpinned by a business model that has avoided acquisitions and focused more on partnering and organically building out the opportunities on offer.

Management team

Neil Helm heads the organisation as Chief Executive Officer, having joined the group in 2007, prior to which he held senior roles at Bankers Trust operating in the foreign exchange division and more recently as an Executive Director at Macquarie. Other key executives including Mark Ledsham, Chief Financial Officer, Simon Griffin, Head of Asia Pacific, and David Higgins, Chief Technology Officer, all of whom have worked within the group for a minimum of four years.

Summary

The OzForex Group represents a core holding for the Fund. While we acknowledge that it's early days, the indications and steps being taken by management to build out an online, organically driven, global business offering, which is disruptive in nature has considerable investment merit. What is now required is management executing well and shareholders showing a little patience. **SFM**

The US economy and the risk of deflation

By definition, a federal deficit is the amount each year by which government outlays exceed government receipts. Governments are notoriously good at running deficits and racking up debts. Whilst at pains to educate us on all the dangers of debt, it only seems to matter to governments when things get out of control. Unable to reign in the deficits, governments over the years have simply allowed debt levels to spiral to levels that now threaten the actual functioning of governments. While the latest debt ceiling episodes being played out both here and abroad are cause for ongoing concern, the actual US deficit numbers are at least now heading in the right direction as **Table 5** below highlights.

Table 5: US Federal Deficits

Year	Deficit Amount
2005	\$US318 billion
2006	\$US248 billion
2007	\$US 161 billion
2008	\$US 458 billion
2009	\$US 1,413 billion
2010	\$US 1,294 billion
2011	\$US 1,300 billion
2012	\$US 1,087 billion
2013	\$US 680 billion
2014	\$US 560 billion*

* *Us Congressional Budget Office estimate*

However, the US government's ongoing quantitative easing program dubbed QE, has raised fears of what can happen when markets are exposed to such distortions. The US Congressional Budget Office estimates the US federal budget deficit will fall to US\$560 billion in 2014. And yet if the Federal Reserve maintains its \$US40 billion of monthly Treasury purchases, as part of its \$75 billion quantitative easing program, it would swallow up the equivalent of the new \$US560 billion bond issuance required to finance the annual deficits.

With the US government budget deficit reducing, there will be a shrinking number of bonds for the Federal Reserve to purchase and in turn, less for the market to purchase. Since beginning its QE program, the Federal Reserve has been the largest buyer of US Treasuries, accumulating a \$US2.1 trillion portfolio, as well as \$US1.3 trillion of mortgage bonds.

Rick Rieder, Chief Investment Officer of BlackRock's fundamental fixed income portfolio, says the problem with quantitative easing is that it is "crowding out" the fixed income market. The world's population is ageing and needs more fixed income investments but the search for these assets is occurring as the world is deleveraging and the Federal Reserve is scooping up \$US45 billion in Treasuries and \$US40 billion in mortgage bonds each month. Rieder notes, "We don't have enough supply of fixed income in the market place. When you add a tremendous size of quantitative easing on top of that, you create this extraordinary distortion of markets."

The so called "smart money" have been backing gold and betting this precious metal will be the asset that will protect them against rising inflation. However, gold's price slump from a peak of just over US\$1,900 per ounce in 2011, to current levels of US\$1,213 per ounce, a fall of 36%, is perhaps a worrying sign that what is unfolding is not necessarily inflation but deflation.

Deflation

Deflation can be broadly defined as a general decline in prices. When the price of assets decline it is known as asset deflation. As we noted earlier, the US government has been instrumental in flooding the market with liquidity, fearful that high employment levels will rob the economy of the very essence of what is needed, consumer spending.

However, with global central banks holding interest rates close to zero and with trillions of dollars now circulating within global economies, the combination of asset inflation and price deflation is a very real possibility. Incoming Federal Reserve Chairwoman Janet Yellen has made her feelings known on the risk of deflation in a quote given in 2009 and highlighted on page two of this report.

Rising share markets and asset prices, most typically seen in property, can suggest things are improving, however, what is plainly obvious is the anemic manner in which economies have struggled to post any decent levels of real growth. Structural changes that have seen the online world disrupt traditional business models and the increasing competitive global market place is forcing new business to be won on price.

The danger with deflation is that it hinders economic growth. Households or businesses that expect prices will be lower tomorrow, are less inclined to buy goods or services today. The flip side for business owners is that deflation increases the real cost of debt carried, with inventories worth less over time. Notably, retailers

including Harvey Norman and Dick Smith have seen the damage inflicted by weak demand and declining asset values.

From here the outlook is unclear. Many in the market still fear a Japan style deflationary period is a possibility and as such, which they believe must be avoided at all costs. The US Federal Reserve's QE program is a testament to the gravity of the situation and underscores what is at stake. The problem with this is that there are no easy solutions and governments, in addressing one issue, have created undesirable outcomes in other areas. The markets are now distorted to the benefit of investors at the expense of savers.

This may not be what we want or desire but in dealing with the aftermath of the global financial crisis of 2008, the US Government needed to respond and as a consequence has ended up with too much debt and too few solutions.

Investors are therefore in the box seat and with this environment as a backdrop, we remain confident that businesses who command market leadership in their chosen field, employ little in the way of capital, carry minimal debt and are prepared to invest in new technology to drive scale and greater efficiency will undoubtedly do well. If anything, these times will suit the better businesses and expose those that are subject to the structural and economic issues now unfolding. *SFM*

Economists –do they know best?

Alan Greenspan the former chairman of the Federal Reserve was appointed on four successive occasions to the top job from 1987 before retiring in 2006. Despite his long tenure, Greenspan is often criticised for having maintained easy monetary settings that lay the foundations for the subprime mortgage crisis which eventually hit the US market during 2008. Since his departure, Ben Bernanke has held the position, having also maintained very loose monetary settings in order to combat high unemployment and sluggish growth. He will shortly be replaced by incoming Federal Reserve Chairwoman Janet Yellen, who will take the role during 2014.

All are very well credentialed economists, however, is that enough? In his new book, *The Map and the Territory*, Greenspan investigates the current failings of US politics and the economy but also opens up to why the Federal Reserve failed to predict the 2008 crisis. Although others have made the connection between easy money policies and the resultant housing bubble, Greenspan offers another view. The increasing level of government entitlements closely corresponded to a decline in the country's savings rate. In turn, this decline in savings was partly offset by borrowings from abroad, reflected in the current level of foreign debt that now stands at \$US5.0 trillion.

Whether this view holds is open to debate, however, what is fascinating is how Greenspan's view of the world has changed following the events of 2008 when the Federal Reserve models failed to predict the financial crisis:

"I've always considered myself more of a mathematician than a psychologist. It all fell apart, in the sense that not a single major forecaster of note or institution caught it. The Federal Reserve has got the most elaborate econometric model, which incorporates all the newfangled models of how the world works-and it missed it completely. I was actually flabbergasted, it upended my view of how the world works."

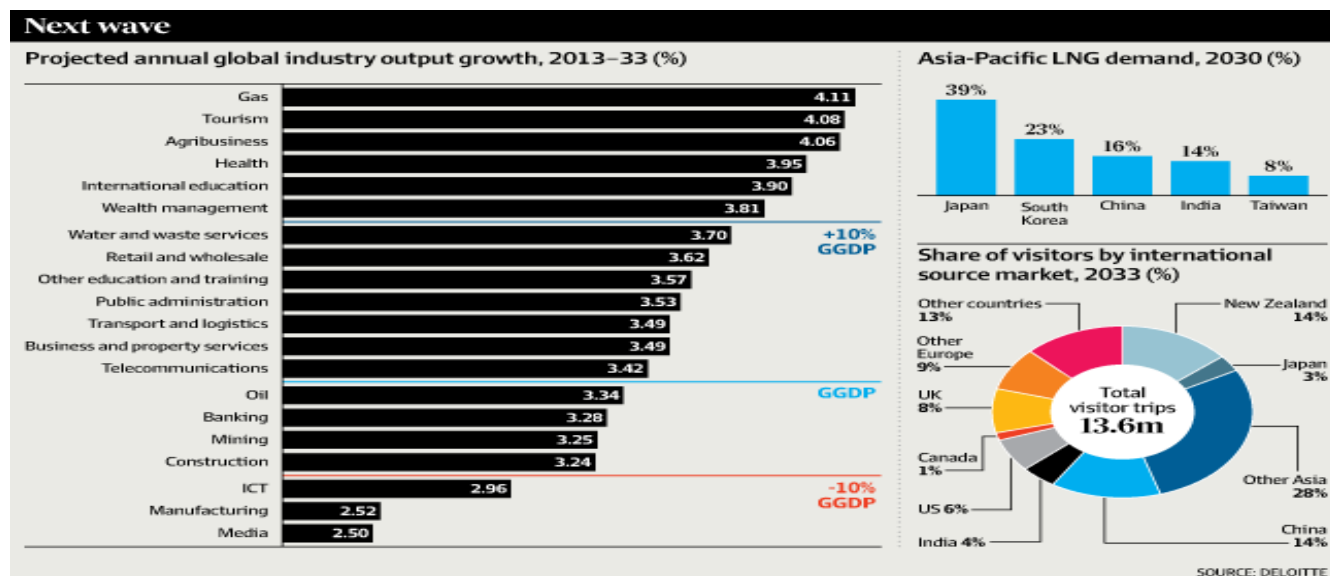
Greenspan had failed to take into account how irrational behaviour and herd mentality could have such a large impact on matters. He now concludes that fear has at least three times the effect of euphoria in producing market gyrations. In view of Greenspan's study of the markets this is an astonishing acknowledgement that goes some way to explain why those who hold high office are not necessarily the best at interpreting the role that human nature plays and its irrational side. Ignore these insights and you expose yourself to some extraordinary shocks as we have witnessed time and again. Berkshire Hathaway's Warren Buffett and 2002 Nobel Prize winner, Professor Daniel Kahneman's work applying psychological insights to economic theory have played their part in educating others to better understand the biases of human nature. Jonathan Wright, economist at Johns Hopkins University, offers an honest assessment on the profession:

"I think economics is in about the same state as medicine in about the 18th century."

As he puts it, economics has moved beyond leeches but hasn't yet reached the equivalent of modern medicine. Economists continue to disagree on just what caused the financial crisis that few saw coming or even how to prevent the next. Some economists still cling to the "Efficient Market Hypothesis" which holds that asset prices reflect all information, while others are more pragmatic, noting that short term price moves may reflect the latest information, while longer term shifts stem from a host of reasons, not all rational. Perhaps joint 2013 Nobel Prize winner for economics, Robert Shiller's observation that, "it's actually easier to predict 10 years out than one year out," is, in our view, closer to the mark. **SFM**

Five super sectors

The local car industry seems to get a lot of air play in this country yet it fails to rank on the list of industries that are likely beneficiaries of Asia's growth. According to the Deloitte Access Economics report, the Australian economy could grow by \$250 billion over the next 20 years by promoting five industries that will benefit from growth in Asia, namely, gas, tourism, agribusiness, health and international education.



* Consulting firm Deloitte Access Economic Report

The report's findings are all perfectly logical. A growing need for cleaner energy to provide for a growing middle class will underpin strong demand for gas. In a similar vein, higher disposable income and improving infrastructure will see tourism surge along with higher demands for better health, education and financial services. The Agricultural produce will be equally sought after by an audience seeking quality and reliability of product.

From an investors perspective there are many ways to benefit from this expected uptake in demand. Some are indirect, where benefits are spread among the broader community as foreign investment grows. More directly, businesses that have established an offshore business presence will enjoy the benefits of a lower Australian dollar as well as an increasingly important international income stream.

A case in point is our educational services, one of Australia's top five export earners, generating over \$15 billion of income a year and employing some 100,000 locals. While English speaking countries are favoured by students looking to study, a sharp decline in foreign student numbers since 2010 has highlighted the risks of not adapting to changing student needs. Most prominent are the requirements of Asian students and in particular the Chinese who represent the largest foreign student contingency in this country, making up nearly one third of all who choose to study here.

In 2010, this number peaked at around 175,000 and has fallen since, hitting 150,000 during 2012. The US has emerged as a key competitor with more Chinese students choosing to study in the US last year than in Australia. Not helping matters is a recent government paper that found it cost about \$44,000 a year to study and live in Australia, a figure that is \$7,000 more on average than in the US and \$14,000 more than in Britain.

Dealing with the cost issue is only one aspect of the debate. The Government, noting the importance of this foreign export earner has taken steps to meet the challenge including allowing students to remain and work for a period following completion of their studies. Universities are also playing their part, adapting their course work to reflect the closer ties with their Asian neighbours. While Australia still lags the US, Canada and Britain for top foreign education destinations, it remains the preferred destination for many parents looking to send their children off to study.

Navitas (NVT)

A leading global player in this sector is listed university pathway operator Navitas. The Fund has had an investment in this business for some years. Navitas was established in 1994, providing students with pathway programs to enter universities. The group enrolls over 80,000 students in programs annually, operates in over 115 locations, and has teamed up with 32 universities and managed campuses, including 10 in Australia, 6 in the UK, 2 in Canada, 5 in the US and 1 in Singapore.

Financially, Navitas reported group revenues of \$732m for 2013, giving rise to a net profit of \$74.6m and earnings per share of 20 cents, leading to the payment of a fully franked dividend of 19.5 cents. The group's key business segment is the university programs division, delivering 57% of group revenue and over 70% of group earnings, being \$415 million and \$106 million respectively as set out in **Table 6**.

As noted earlier, the industry has struggled in recent times to overcome regulatory issues in attracting new students. This has seen the group's profit's flat lining since 2011, which also included an acquisition that has yet

to fulfill management’s original expectations. However, we suspect the outlook may improve from here, despite the ongoing structural threat of free online university courses.

At its core, the group’s student enrolment number, measured as equivalent full time students, totals some 14,500 and is made up of 5,500 offshore with the balance being domestic. With each student paying upwards of \$25,000 per annum to attend, the financial return metrics for Navitas are very attractive and underscore the potential upside should management get the offering right.

Table 6: Navitas divisional earnings

EBITDA (\$m)	FY13	FY12	Δ%
University Programs	106.1	102.9	3
SAE Group	25.1	26.4	(5)
Professional and English Programs	19.3	13.9	39
Divisional EBITDA	150.5	143.2	5
Corporate costs	(20.5)	(16.4)	25
Group EBITDA	130.0	126.8	3



The group entered the US market in 2009, establishing five pathway programs. From a standing start these universities are now reaching an inflection point. With an estimated 850 students now enrolled in the US program and with operations now close to breakeven, expectations are high that student numbers should rise strongly over the ensuing years.

Navitas has a high fixed cost base, with margins rising materially as student numbers grow. For a new campus, losses are incurred until a typical breakeven intake level of circa 400 students is reached. As student numbers move beyond 1,000 per campus, operating margins pass 25% and continue upwards, exceeding 45% beyond 2,500 students.

There are expectations that having weathered a difficult startup period, student numbers should rise materially from here, with estimates of 4,000 – 5,000 total full time US students by 2018. On this basis revenues should lift from \$13 million to a figure closer to a \$110 million along with net profits of \$20 million. There are a few ifs and buts in all this, but our sense is that Navitas may finally be seeing the benefit from a number of years of business investment. **SFM**

Business snippets

1. Breville Group (BRG)

This quarter the team visited kitchen appliance designer, developer and distributor, Breville Group. The company is listed on the local stock exchange and has a current market value of \$1 billion. With a history dating back to 1932, the Breville brand is an established designer of mid-tier kitchen appliances, including iconic products such as the Breville snack 'n sandwich maker and the Breville kitchen food whizz.

Our visit reinforced management's key business tenor, that product innovation sits at the heart of everything the group undertakes. CEO Jack Lord refers to this as "Food Thinkers", with a conscientious effort to produce kitchen appliances that combine quality with usability to drive a better food experience. Their efforts have not gone unnoticed with net profits lifting from \$15.8 million in 2009 to one just shy of \$50 million in 2013. Company sales are set to pass \$500 million this year while the group's fully expensed research and development investment totalled \$6.6 million.

The group's push into international markets is gaining traction. Targeting the premium end of the market, the brand Breville is highly sought after in the key US market with retail distributors that include Williams Sonoma. In addition, Breville have recently entered the UK market under the "Sage" brand in partnership with celebrity chef Heston Blumenthal.

While management have high hopes that this combination will succeed, a continuing legacy issue concerns ownership rights to the Breville brand in Europe. When previous Breville management sold off the European rights back in 1982, few would have guessed the ramifications of such a move. Today, European ownership sits with US based Jarden. Unfortunately, this \$US4.8 billion company and owner of a diverse range of consumer brands including Sunbeam, is unlikely to let this franchise go cheaply, so any attempt by Breville to wrestle back ownership will no doubt come at a hefty price.

Breville's commitment to product design has them competing successfully with top end brands such as KitchenAid and Cuisinart. The Breville management team provides a perfect example of what can be achieved over the long run when there is a preparedness to reinvest in order to deliver globally competitive products notwithstanding the short term earnings impact of sticking to such a strategy.

2. Technology One (TNE)

Technology One, is an Australian based enterprise software provider that listed on the stock exchange in 1999 with a market value of \$100 million. Today, the group's worth exceeds \$700 million, with net profits reaching \$27 million during 2013 on revenues totalling \$180 million.

Having profiled the business in our June 2012 quarterly newsletter we followed this up with a piece titled, "*Technology: avoid it at your peril*", in our most recent September quarterly. There we explained the importance of why businesses must continue to embrace technology. To this end, Technology One is preparing to launch their software services offering on the cloud during 2014.

Put simply, a cloud based solution, allows a business to rent or lease computer capacity rather than the traditional method of buying and owning the hardware. For business, the move onto the cloud appears logical

and importantly provides business owners with increased flexibility. The role of Technology One is to manage these services on behalf of the client. In exchange, the client pays the company a yearly fee thereby eliminating the need to maintain and employ a dedicated IT department.

Technology One's experience in transitioning its own operations to the cloud, has led to a savings benefit of 20% to 30%. Management are confident clients will achieve similar results by embracing the offering. In an environment where growth is hard to achieve, lowering costs and delivering savings becomes just as important.

How the Economic Machine Works by Ray Dalio

Bridgewater Associates based in the US and founded by Ray Dalio, is a global macro investment management firm. A recent posting on youtube.com, titled, *How the Economic Machine Works*, (available on our new website via the News and Insights tab under Items of Interest), is worthy of a look. Dalio's 30 minute video provides a simple framework for understanding how the economy works with a particular focus on credit cycles over the short, medium and long term. We encourage you to find the time to view his work, as it provides a big picture perspective on what is often a difficult subject to grasp. Suffice to say that we will leave it up to you to form your own conclusions post your viewing. Enjoy! **SFM**

HECS and governments

While on the subject of education and costs, speculation has been rife that the Federal Government would look to sell off its higher education fees (HECS) debt portfolio to recoup much needed capital. At last count student HECS debt owed to the government stood at \$23 billion, with this figure predicted to hit \$42 billion by 2017.

As a general rule, all students who attend Australian tertiary education institutions are charged HECS. However, government loans and subsidies are in place to relieve the costs of tertiary education in Australia. Under the HECS program students can defer their payments, receiving in effect an interest free loan and only repaying the loan once gainfully employed and earning beyond a minimum income level that currently sits at \$51,300.

So why sell off the HECS debt and how much would they get? In this case, there are some very good reasons to believe that something could happen especially when considering the dollars involved and the Government's need for new funds. However, as there is no interest on HECS and some twenty percent of the debt is never repaid a significant discount would have to apply to the portfolio should anyone entertain the notion of buying the student loan book.

Media reports suggest that this figure is likely to be around \$13 billion, a discount of some 50%. Treasurer Joe Hockey's office has said that HECS securitisation is not current Coalition policy, with the key word being "current". And there is a precedent of governments selling off HECS debt. During the late 1990's, the UK Government sold off two tranches of student debt totaling about £1 billion each.

In June this year the Cameron Government announced plans to sell off £10 billion of student loans. And in a bizarre twist, the newspaper The Guardian reported that Rothschild had also advised the government to underwrite investors' risk with a financial instrument known as a synthetic hedge, to in effect use the public finances to guarantee returns to private investment. These are big numbers and at some point some acknowledgment has to be made of the debt our government carries and its true underlying value. **SFM**

Why good management matters.

Back in our June 2012 newsletter we highlighted a quote from New Zealand Prime Minister John Key when addressing the Menzies Research Centre. The following is an extract given at that time;

"By making a series of sensible decisions, which build on each other and which are signaled well in advance, and by taking most people with you as you go, you can effect real and durable change, which won't simply be reversed by the next lot who come into government. I am at pains to point out most days in parliament - jobs are only created when business owners have confidence to invest their own money to expand what they are doing or to start something new."

The role of management in any business endeavour cannot be understated, a point we had made countless times over the past decade. While this requires a judgment call and is subject to individual interpretations or even biases, it nevertheless forms a critical part of our investment selection process. Without the right management team in place, irrespective of how subjective that call may be, we just won't invest.

But let's get back to New Zealand's Prime Minister John Key and his team. Elected as Prime Minister in November 2008, Key was confronted with an economy in recession and one that had become welfare dependent. To make matters worse, New Zealand couldn't rely on the security blanket of the resources boom to help soften the impact of the impending financial crisis.

Rather, as Key noted in his address to the Menzies Research Centre, an entirely different approach was required. Key, along with New Zealand's finance minister Bill English, went about the task of rebuilding, as English explained in a recent discussion with the Australian Financial Review in December.

"People could see action was necessary. But we took a long term view of the next four to five years, rather than two or three. It was 18 months before we set down our agenda in the 2010 budget and we had established trust with the public by sticking to what we'd said, but also outlining our larger objectives. A lot of it comes from articulating your objectives positively - about doing the job better, rather than just phrasing it in terms of making savings."

Simply spending more money wasn't the answer, rather the commitment made was to better public services by making the system more efficient. The term "living within your means" could so easily be applied to this duo, with new budget spend items offset by reductions elsewhere.

Today, the New Zealand economy is on firmer ground. Business confidence is at 15 year highs, the federal budget is on track for a 2015 surplus and the economy is growing ahead of Australia's, with the OECD predicting 3.3% GDP growth next year. Tough decisions were necessary but as minister English insists:

"Success is less about dramatic change and more about properly measuring achievements, targeting the desired results and holding people to account."

The plan as unveiled by English, carried with it an acceptance that change was needed:

"We had excessive consumption funded by debt and a shrinking export sector so we made the argument for rebalancing the economy. That meant talking about taxing property speculation and consumption more and taxing investment and work less."

The result was a cut in the top marginal tax rate from 39% to 33%, aligning it with trusts, dropping the corporate rate to 28% and lifting the GST from 12.5% to 15.0%. All these changes are not to say that everyone is happy or totally in agreement, but the New Zealand approach is both refreshing and transparent. The runs are now on the board and the country's economic direction looks solid, courtesy of a sound and disciplined management team. And investors seem to be in agreement, with the New Zealand stock market outperforming our own local market over the past one and five years as highlighted earlier in our report.

So if you think good management doesn't rank high on the list when assessing the merits of any new investment, think again, because it just might be a company's best asset.

Selector ten years on

Milestones should be celebrated or at the very least reflected upon. Ten years ago Selector Funds Management was born. From the outset, the underlying desire was to run a funds management business for a select number of investors. Looking back we have no regrets but lessons have been learnt nonetheless.

They say to understand a business you need to run one. On this score we concur. We have had our challenges and our setbacks, but fortunately, the will to build the business and deliver to our investors, the returns they rightly expect, has us on the right track.

Today, funds under management comprise both private investors who have shown genuine loyalty over the years and in more recent times the awarding of investment mandates from leading institutional investors.

Our people are our biggest assets and in this regard we are fortunate that we have a group of executives that offer diversity and experience. Our original team of Martin Greenberg as Chairman, alongside fund managers Corey Vincent and Tony Scenna has been expanded with the addition of experienced executives George Giovas and John Maragiannis. One can never underestimate the importance of youth to any business and we are fortunate to have on board Robert Lapsley as well university student Sam Bernard.

However, this all counts for naught if we cannot deliver our clients personal service and market competitive performance. On this point we are extremely proud that we have been able to deliver excellent returns over a number of years.

On a final note, we would like to extend our gratitude to those who have entrusted their capital for us to manage. It goes without saying that to do a good job it helps if you love what you do. Rest assured we are all aligned, to build upon what has been achieved thus far. **SFM**

Company visit diary December Quarter 2013*October*

SOM	Somnomed investor briefing	25/09/13
OFX	OzForex Group IPO investor briefing	26/09/13
SUL	Super Retail Group investor briefing	09/10/13
WOR	WorleyParsons investor briefing	10/10/13
COH	Cochlear annual general meeting	15/10/13
PXS	Pharmaxis conference call	17/10/13
FXL	Flexigroup investor day	22/10/13
TRS	The Reject Shop conference call	23/10/13

November

EGP	Echo Entertainment investor briefing	05/11/13
FOX	21st Century Fox quarterly conference call	06/11/13
VRT	Virtus Health annual general meeting	06/11/13
ALU	Altium annual general meeting	06/11/13
AGI	Ainsworth Game Technology site visit	07/11/13
BRG	Breville Group annual general meeting	13/11/13
EGP	Echo Entertainment annual general meeting	13/11/13
JHX	James Hardie Industries PLC quarterly conference call	14/11/13
PXS	Pharmaxis site visit	14/11/13
OFX	OzForex Group half year results conference call	20/11/13
WOR	WorleyParsons conference call trading update	20/11/13
FXL	Flexigroup annual general meeting	20/11/13
TNE	Technology One full year results briefing	25/11/13
ALQ	ALS half year results briefing	25/11/13
ANN	Ansell acquisition conference call	26/11/13
ALL	Aristocrat Leisure full year results briefing	26/11/13
CTX	Caltex Australia site visit	27/11/13
MYS	MyState Financial conference call	28/11/13
N/A	Isentia IPO macquarie investor conference	29/11/13
FLN	Freelancer macquarie investor conference	29/11/13

December

SRX	Sirtex Medical site visit	03/12/13
OTH	Onthehouse investor day	03/12/13
CVO	Cover-More Group IPO investor briefing	03/12/13
BKL	Blackmores conference call	04/12/13
TNE	Technology One conference call	04/12/13
CSL	CSL R&D investor day	05/12/13

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