

FUND PERFORMANCE:

The Fund gained **18.2%** (net of all fees) for the September 2005 Quarter. The All Ordinaries Accumulation Index rose 10.0% in this period. For the eleven months ending September 30 2005 the Fund gained **48.1%** (net of all fees), inclusive of the 1.98 cent distribution to unit holders for the period to 30 June 2005. The All Ordinaries Accumulation Index rose 26.1% over the same period. See the table on page 5 for the Funds performance since inception on a monthly basis. **SFM**

BIG PICTURE:

Last quarter we penned that volatility in stock markets is totally normal. In the context of the June 2005 quarter it was appropriate because of large back-to-back monthly gains. This quarter it may be appropriate because of rapid day falls. Whatever the case, it is comforting to know volatility is normal.

“Investors should expect the market to be highly volatile”

We also noted that investors should expect the market to be highly volatile at least one third of the time. In fact, high volatility (+ or – 4% movement in a month) was experienced by the local market 39% of the time in the 24 years to June 2005. Big falls occurred 14 % of the time. And a total of 1 year out of 24 years had falls and gains of more than 10% each month!

The key take away point is that your investment in the Selector Fund may be volatile in the short term. But in the long run it comes down to stock selection.

“Low quality companies need large amounts of capital to generate small profits”

Stock selection is about finding quality companies, looking for durable aspects of a business that will out last market volatility. This quarter we focus on businesses that can deliver outstanding results that **don't** require huge amounts of capital.

Generally speaking low quality companies need large ongoing amounts of capital to generate small profits. They are capital-intensive. A continuous hunger for capital will drive up debt or require increasing share issues. When ever we see an annual report with a nice profit chart we look for the corresponding changes in debt and equity levels. A rising profit can mask a lot, especially if debt or equity levels are increasing at a similar or greater rate. An example of a capital-intensive business is **Qantas**. New planes required to replace old ones come at a huge capital cost – with little scope to generate decent returns on new capital invested. And maintenance capital expenditure, the annual investment required to keep the planes in operational condition remains a constant drain on capital resources.

“A good business requires low levels of capital”

In contrast a good business requires low levels of capital or can quickly repay the capital by generating high returns from the activities it undertakes. Secondly, maintenance capital expenditure will be low. Instead, any capital expenditure that is undertaken will usually be directed towards expansionary activities that generate similarly high returns. Recently listed **Select Managed Funds Limited (SEM)** typifies a high return business. **SEM** has no inventory. As a service based business operating in the superannuation arena, the group generates wonderful profits with little need for additional capital.

Reconciling the net profit with the cash flow statement starts the process of making the distinction between high quality and low quality businesses. This is where we can get a feel for the replacement capital expenditure and maintenance capital expenditure (should be similar to depreciation) required. In other words, we are trying to determine the **free cash flow** that management can send back to shareholders. And in particular, how this free cash flow differs from the company's reported net profit.

“We want close to a 15% return to encourage us to risk our capital in a share investment”

Two ratios integral to our stock selection process are return on equity (**ROE**) and return on capital employed (**ROCE**).

ROE is simply a matter of dividing the net profit after tax (in the “statement of financial performance”) by the shareholders equity. An **ROE** below 10% is marginal if you consider the risk free cash rate is 5.5% and the average cost of capital being around 8-10 %. In short, we want close to a 15% return to encourage us to risk our capital in a share investment.

ROCE takes **ROE** a step further by including the use of debt. For our purposes **ROCE** is calculated by dividing the earnings before interest, tax and amortisation (**EBITA**) by the capital employed. Capital employed equals shareholders equity plus interest bearing debt less cash. **ROCE** shows the performance of the business no matter how management has chosen to fund it. It should be noted that an **ROE** or **ROCE** at any single point in time is a quick guide; the real value comes from the trend that these ratios deliver over time. We look at a few examples in the table below.

The table lists (alphabetically) several stocks held in the Selector Fund. This is a snapshot of the **ROE** and **ROCE** at a point in time. All figures are extracted from respective 2004-05 Annual Reports.

Qantas is a standout “capital-intensive” business with massive debt, both on and off balance sheet through aircraft leases. The **ROCE** at 9.7% is marginal at best, but well below par relative to our 15% target. The **Qantas** story is further weakened when off balance sheet leases are considered. Selector Fund does not hold **Qantas**. And yes that number in the sixth column does indicate over \$5 billion in debt!

“A key element of stock selection is to recognise ... business characteristics ... the ingredients for future ROCE superiority”

We have included **Flight Centre** to emphasis the different business models within an industry grouping. **Flight Centre** is a service business with no inventory and certainly no expensive aircraft and therefore no need for large lumps of debt. Maintenance capital expenditure is limited to shop re-fits and IT upgrades. With a return of 33%, **Flight Centre's ROCE** is indeed impressive. In fact, if we take into account the group's other liquid assets (company owned bonds and fixed interest assets totalling some \$174m) for our **ROCE** calculation the figure balloons out to an obscenely high 75%. Either way the **ROE** and **ROCE** are starkly different to that of **Qantas**.

Generally speaking the price of a business will reflect a superior **ROE** and **ROCE**, particularly when a track record of earnings certainty also exists. For this reason a key element of stock selection is to recognise industry and business characteristics that provide the ingredients for future **ROE** and **ROCE** superiority.

Company	NPAT \$M	Shareholder Equity (SE) \$M	ROE %	EBITA \$M	SE + net debt – cash \$M	ROCE %
Cochlear	54.5	165.8	32.8	78.9	263.2	29.9
Cabcharge	27.2	137.9	19.7	37.3	107.9	34.6
Flight Centre	67.9	387.4	17.5	107.9	323.5	33.3
Qantas	763.6	6,426.90	11.9	1,136.90	11,693.90	9.7
SAI Global	11.4	68.9	16.5	17.5	83.5	20.9
Select Managed Funds	14	62.8	22.3	21.2	46.9	45.2
Vision Group	6.7	64.8	10.3	19.4	126.9	15.3

On our **ROE** and **ROCE** criteria, it is easy to see how **Cochlear**, **SAI Global** and **Select Managed Funds** (no relation to us) meet or exceed the requirements we have set. **Vision Group** however is a different kettle of fish.

Vision Group is Australia's leading provider of ophthalmic care, consultancy and surgical solutions. This is a high margin business with significant barriers to entry and a growing patient base. **Vision's** unique business model has achieved first mover advantage and strong doctor support from Australia's leading ophthalmic surgeons. The strong cash flow and low capital expenditure requirements of the business should result in rapid repayment of debt and a strengthening **ROE** and **ROCE** in time. We expect to see both **ROE** and **ROCE** trending up for this one. **SFM**

AN HOUR WITH REG KERMODE OF CABCHARGE

Reg Kermode is a spritely old chap. He asked us what it was like outside, having arrived at his office before daybreak. Not bad for someone who founded the **Cabcharge** business 30 years ago. The 4 storey Riley Street offices in the trendy part of East Sydney are in the books for \$4.1M. Reg laughed as he told us they had the rights to go up to 14 storeys. He reckons the building is worth 3-4 times the book value. We see this as typical of the conservative nature of the group.

The core business is simple with a high **ROCE** and a repetitive 10% take of all **Cabcharge** "blue docketts" (paper payment note) and a 6 - 8% slice of credit cards transactions processed from over 17,000 participating cabs. The introduction of GPRS (General Packet Radio Service), a superior payments technology and e-tickets to replace the traditional "blue docketts" will see costs driven out of the business and additional margin improvement.

"Westbus gets paid for ...carrying fresh air"

That said, what we really went to see Reg about was the Westbus acquisition. At the recent full

year 2005 results briefing, Reg told those in attendance "that shareholders had the right to be excited about this acquisition", while other **Cabcharge** executives described it as a "no brainer".

The Westbus model is a simple cost plus contract with base EBITDA margins of 16.5%. This is the first time this UK model has been embraced in Australia by Government and is a major catalyst for industry change and significant rationalisation opportunities.

Westbus gets paid for services provided and kilometres travelled even when carrying "fresh air". The State Government collects and takes the fare risk. They also bare risk on funding workers compensation, fuel costs, capital expenditure on bus fleet and maintenance capital expenditure on bus fleet. Upside exists in anything that can be generated above the contract, such as advertising, cost reductions from improved efficiencies, reduction in workers compensation and additional or new routes.

Cabcharge has entered into this acquisition with 51% JV partner ComfortDelGro, the second largest listed land transport company in the world, who are also making their first foray into the Australian market. ComfortDelGro and **Cabcharge** have a 30 year working relationship. We would not be surprised to see these two groups come together in the fullness of time. As for Reg, he loves his work and after a bit of a stretch and a smile he looked fit enough to go a few rounds, not bad for 79. **SFM**

WATCH THIS SPACE

A quiet revolution is changing the landscape of the unlisted world of credit unions and the merged players will have a growing impact. Credit Union of Australia has unveiled plans to merge with the Australian National Credit Union creating a lender with \$5 billion in assets and some 75 branches.

"Stodgy entrenched management are sitting on unrecognised jewels"

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This is the latest in a bout of rationalisation of Australia's credit unions. This space is intriguing. In more than a handful of cases stodgy entrenched management are sitting on unrecognised jewels in the form of retained profits owned by the members – deposit holders. Corporate activity will bear fruit for often unsuspecting deposit holders, as is currently the case with Home Building Society looking to merge with StateWest Credit Society.

At Selector Funds Management we watch with interest, having developed some strong industry relationships and ever hopeful that we can position ourselves in the event that fresh capital is required by a management team with the vision to move forward as a leader in this space using a publicly listed vehicle. **SFM**

COMPANIES VISITED DURING THE LAST QUARTER:

July	Felix Resources site visit	FLX	Sept	Vision Group results briefing	VGH
	Unitab site visit	UTB		Tattersall's	TTS
	Domino's Pizza site visit	DMP		Sky City Entertainment results	SKC
	Fantastic Furniture site visit	FAN		STW Communications results	SGN
Aug	Pharmaxis site visit	PXS		Keycorp results briefing	KYC
	IMB Society			Petsec Energy site visit	PSA
	Somnomed Limited	SOM		Babcock & Brown Wind Farm	BBW
	Progen	PGL			
	Alumina results briefing	AWC			
	Telstra results briefing	TLS			
	Cochlear results briefing	COH			
	Sigma	SIG			
	Resmed results briefing	RMD			
	SAI Global results briefing	SAI			
	Macquarie Airports briefing	MAP			
	Jubilee Mining	JBM			
	Infomedia results briefing	IFM			
	Transonic Travel results briefing	TNS			
	Salmat results briefing	SLM			
	Babcock & Brown briefing	BNB			
	Publishing & Broadcasting	PBL			
	Keycorp	KYC			
	Cabcharge results briefing	CAB			
	Fantastic Furniture briefing	FAN			
	Waterco	WAT			

"I would say that at any given point in history, including when stocks were the cheapest, you could find an equally impressive list of negatives [as there is today]... We don't pay any attention to this kind of thing... Going back to '59, I can't think of any discussions Charlie and I have had in which we've passed on something because of a view on macro conditions... Show us a good business tomorrow and we'll jump."

Charlie & Warren

MONTHLY PERFORMANCE DATA:

Month Ending	Unit Price	SF Gain %	SF Monthly %	AOAI	AOAI Gain %	AOAI Monthly %
30-Sep-05	\$1.4611	48.09	6.44	26,559	26.14	4.75
31-Aug-05	\$1.3727	39.25	8.76	25,354	20.42	2.18
31-Jul-05	\$1.2621	28.19	2.09	24,814	17.85	2.77
30-Jun-05	\$1.2556	25.56	11.62	24,146	14.68	4.46
31-May-05	\$1.1249	12.49	5.35	23,115	9.46	3.41
30-Apr-05	\$1.0678	6.77	-5.43	22,352	6.16	-3.78
31-Mar-05	\$1.1291	12.91	0.72	23,231	10.33	-0.74
28-Feb-05	\$1.1210	12.09	4.68	23,405	11.16	1.80
30-Jan-05	\$1.0709	7.09	2.16	22,992	9.20	1.33
31-Dec-04	\$1.0483	4.82	2.33	22,690	7.77	3.07
30-Nov-04	\$1.0244	2.44	2.44	22,029	4.63	4.63
1-Nov-04	\$1.0000	0.00	0.00	21,055	0.00	0.00

* Note – Unit prices are struck on a monthly basis; intra-month prices are indicative only

Unit prices and performance are independently calculated by DDH Graham Limited www.ddhgraham.com.au

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