

S F M

Funds Management

Q1 2004 NEWSLETTER

SELECTOR FUNDS MANAGEMENT LIMITED

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1 YEAR GROSS RETURN WITH SFM_{MP}

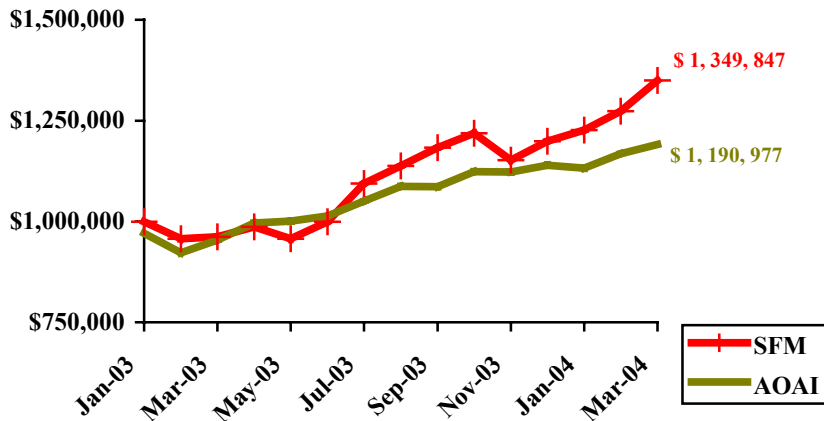
1 Year return	\$ Valuation	SFM return 1 Year	\$ AOAI	AOAI return 1 Year
4x Q's 2003	1,199,095	19.91%	1,139,900	13.99%

QUARTERLY GROSS RETURN WITH SFM_{MP} SINCE INCEPTION*

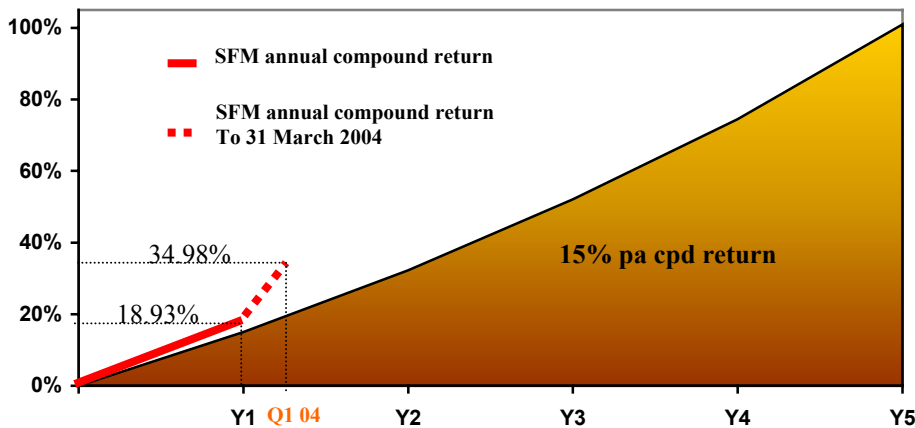
Last 4 Quarters	\$ Valuation	% SFM Quarterly return	SFM return since inception	All Ords Accumulation Index	% AOAI Quarterly return	AOAI return since inception
Jun Q 2 2003	999,795	3.94	34.98 %	15,818	6.25	19.08 %
Sep Q 3 2003	1,183,388	18.36		16,941	7.10	
Dec Q 4 2003	1,199,095	1.33		17,787	4.99	
Mar Q1 2004	1,349,847	12.57		18,581	4.46	

*Selector Fund Start Date 21/01/2003. Valuations adjusted for dividends previously not included

GROSS VALUE OF \$1.0M INVESTED WITH SFM_{MP} SINCE INCEPTION



TRACK RECORD AGAINST AIM OF COMPOUNDING AT 15%



Comment: We have had a great quarter and again we acknowledge the tail wind provided by the climate for equities. A couple of things we would like to make clear...

Warren Buffett does not work at Selector & surprise, surprise nor is he our Chairman.

As a result we don't hold out that we do things the same way as Buffett (i.e. we can't afford to buy 100% of a company, which is what he typically does. This is conveniently overlooked by Buffett devotees). Instead we ask ourselves a question. Can we double our money on this investment over 5 years to achieve our goal of a 15% compound return? If the answer is yes, we use a 3-step process to build an investment road map that has milestones we can check off on the journey and road signs to warn us along the way.

1. Qualitative and Quantitative investigation
2. Develop investment roadmap
3. Road map / *Milestones / **Road signs

Qualitative			Quantitative		
Management Qualities	Owner Qualities	Focus	Growth	Business Qualities	Balance Sheet
Individuals who we can trust	Material equity holding in the business	Niche or franchise	Reinvesting in the business	Businesses that we can understand	Low debt levels
Possess the drive to take the business forward	Share a common bond with ordinary shareholders	Adapt to business conditions. Do not succumb to share market pressure	Drive & resources to deliver real EPS growth	Well positioned in chosen industry	Simple structure
Clear articulation and consistency of business strategy	Track record		Free cash flow	Strong or improving financial ratios ROE = return on equity, ROA = return on assets	Manageable Cap Ex = Capital Expenditure requirements

↓ INFORMATION USED TO BUILD AND REVIEW ROAD MAP ↓

Investment Road Map
1. We build an investment Road Map
2. Road map has milestones – Quantitative & Qualitative
3. Milestones may act as triggers – Buy / Sell / Hold
4. Road signs alert us to changes in our road map
5. Road signs are heeded and investigated
6. Road signs can act as triggers – Buy / Sell / Hold

***Milestone** = Management or SFM expectations & forecasts

****Road sign** = Any change to Quantitative or Qualitative factors listed. See also Page 4 Big Picture.

Portfolio: In mid March, SFM met with the brand new Aristocrat (ALL) CFO Simon Kelly. Kelly is a change management specialist having had 5 separate roles in 8 years at Goldman Fielder, heading business units that required turn around. We established that both Kelly and Paul Oneile (CEO) took on their respective roles, knowing full well that a “cultural” change was needed but holding a common view that ALL remained the world leader in its space –i.e. distributor of video programs to the worldwide gaming market. SFM shares the view that ALL is a leader but we gained a bump and bruise before being rewarded. But even more importantly, this view was recently reflected in the Goldman Sachs (GS) 4th Annual USA Slot Machine Survey. GS state,

“ The increase in popularity of Aristocrat Leisure games was remarkable.”

“Aristocrat games were mentioned 19% of the time as having the highest win per machine. This ranked second only to IGT”. The report goes on to conclude that ALL has established itself as a clear No.2 in the USA behind IGT. Having gained an insight into what attracted the new team we tried not to dwell on the past. However, it became clear very quickly that credit control and debtor management in overseas operations has been reined in by new systems and procedures as a result of past failings (to our surprise no systems existed to chase overseas debtors under previous management). We also gained insight into Kelly’s view on litigation – while ALL cannot comment on insurance – it is also clear this will not be a distraction to management, who prefer to focus on quality earnings growth. We note that litigation is likely to be drawn out and our guess is that the class action may not have a huge following. In any case, future years of quality earnings growth is by far the best panacea for what will in time be viewed as a “one off” from yesteryear.

We expect ALL to surprise on the upside in the near future as the USA participation model gains further traction and the financial benefits become fully understood by investors. This is a powerful strategy that allows ALL to share in the daily winnings from an individual machine. Machines are owned and serviced by ALL in banks of 8. Currently ALL has 2755 machines on participation in the USA (IGT have 35,000 earning 50 – 70 USD per day). ALL had a substantial reduction in debt in the full year and now has a focused team at the helm. ALL scores many direct hits on our matrix above.

SFM

Portfolio: We think that saying no to most investment opportunities is important and can be difficult if you do not have a criteria and method for the sorting process. We attended the Zinifex (ZFX) institutional briefing in March. The first thing that struck us was the huge capital expenditure required just to stay in business, at + \$200 million in year 1 alone. This is almost Qantas – like. We avoid these types of capital-intensive businesses when the capital is used just to stay in business. This is a very different proposition to capital expenditure that is used to grow a business (i.e. ALL had cap ex of \$30M in 2003 of which \$18M was used to place machines into the participation model – see review above). Secondly, ZFX concentrates are shipped to Tasmania, Clarkesville (USA) and the Netherlands. We note that shipping freight rates are rocketing north – so much so that the ACCC is considering intervention. And for a stock touted to give exposure to a resource boom ZFX has a very high exposure to smelting. Our understanding is that refining costs are falling – this is the case at Korea Zinc, the world’s largest zinc smelter. On a comparative basis

Kagara Zinc stands head and shoulders above Zinifex.

KZL also fits neatly into each of the criteria’s we have listed on page 2 (other than Niche / Franchise). We have followed KZL closely over the past year – and we will embark on our second site visit in June 2004.

The risk profile at **KZL** has now dropped substantially and we anticipate the next milestone of strong free cash flow will be achieved this month and will continue for a considerable period of time. And with management having significant equity we expect to see a dividend policy unfold. In resource stocks, grade is king and **KZL** is a high-grade operation with low cash operating costs. Surprises may come from the high-grade copper that has been partially defined. In contrast to **ZFX**, **KZL** trucks all concentrates to Korea Zinc in Townsville, who take 100% of production. In relation to zinc we also note the following comment from a leading research house. “Zinc’s fundamentals are improving. Demand growth is picking up and we believe that the global market has now moved into deficit. In the longer term we see relatively few major greenfield opportunities for zinc producers, so that there is potential for the global market to remain in deficit throughout our forecast period (2008)”. **SFM**

Big Picture: Selling is an aspect of investing that is often overlooked and rarely discussed. However, it really makes or breaks a good investment strategy. We have our own simple rules that make sense to us – not Warren Buffett rules or any one else’s. Firstly, emotion must be removed from selling. The No.1 emotion that results in selling an investment at the wrong time is fear. Two examples of fear are selling for fear of success – i.e. locking in what seems like a good profit. And secondly, selling for fear of failure – i.e. fear of losing too much money. Both of these are a result of focusing on price action alone. These are two of the worst reasons to sell. We say this for the simple fact that selling as a result of fear and price action demonstrates a lack of understanding of the fundamentals. And if this is the case

you are not investing ... you are speculating.

Discipline and confidence are required to establish and adhere to your own selling rules. We focus on the exact reasons that we entered an investment (see matrix page 2). If one of these factors change, it acts as a “**road sign**” – we simply heed the warning and investigate. From here we make a decision to act or take no action. This does not guarantee that we are correct but it maintains a focus on the fundamentals. A common “**road sign**” might be a change in debt levels – this deserves investigation every time. We will sell as a result of a “**road sign**” that demonstrates the company no longer meets our requirements. Typically, on investigation, we find that one “**road sign**” leads to another. In sharp contrast to this, we will also adjust a winning position – so as not to create excessive risk in the portfolio as the position grows of its own accord. This allows us to hold onto a strong performer longer, rather than getting off a winner too early. We mention this in context to our philosophy of having a concentrated portfolio. **SFM**

“April is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, October, November, May, March, June, December, August, and February”.

Mark Twain

Investing with Selector Funds Management Limited.

**The minimum investment in the fund
is \$500,000 or \$100,000
for those investors who meet the
wholesale exemption criteria
within the Corporations Act.**

Back issues of this newsletter – www.selectorfund.com.au or contact us on

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Selector Diary Q1 2004

Companies visited in Q1 2004		
08-01-04	SAI Global	SAI
14-01-04	Sirtex	SRX
21-01-04	HPAL	HPX
29-01-04	IT & E	ITE
02-02-04	Prana Biotechnology	PBT
09-02-04	Gunson Resources	GUN
10-02-04	Pacific Brands	PBG
12-02-04	Telstra	TLS
12-02-04	James Hardie	JHX
12-02-04	Record Investments	RCD
17-02-04	Kimberly Diamions	KIM
17-02-04	Cochlear	COH
19-02-04	Ion	ION
19-02-04	Globe International	GLB
19-02-04	Flight Centre	FLT
20-02-04	Australia Energy	AEN
24-02-04	Keycorp	KYC
24-02-04	Kaz Group	KAZ
25-02-04	Infomedia	IFM
26-02-04	Macquarie Infrastructure	MIG
26-02-04	Millers Retail	MRL
27-02-04	DCA Group	DVC
27-02-04	Arrow Pharmaceuticals	AWP
02-03-04	National Foods	NFD
03-03-04	Peppercorn Management	PMG
03-03-04	Peppercorn Investment	PIV
03-03-04	AAV	AVV
04-03-04	SFE	SFE
09-02-04	Zinifex	ZFX
10-03-04	Salmat	SLM
10-03-04	STW Group	SGN
15-03-04	Aristocrat Leisure	ALL
16-03-04	Pharmaxis	PXS
19-03-04	Amadeus Energy	AMU
23-03-04	Sigma	SIG
23-03-04	Toll Holdings	TOL
23-03-04	Willmont Forests	WFL
24-03-04	So Natural	SNF
26-03-04	Kagara Zinc	KZL
26-03-04	MPI Mines	MPM
30-03-04	Transonic Travel	TBA
30-03-04	Treasury Group	TRG

SFM MP Alphabetic order of Top 10 Holdings		
1	ABC Learning	ABS
2	Aristocrat Leisure	ALL
3	Kaz Group	KAZ
4	Peppercorn Inv Trust	PIV
5	Reece Australia	REH
6	Sigma	SIG
7	STW Communications	SGN
8	Suncorp	SUN
9	Ten Network	TEN
10	Petsec Energy	PSA

SFM MP Activities during Q1 2004	
Share transactions	5
Purchases	3
Sales	2
Takeovers	-
# Investments in fund	26
# Investments > 3% fund	14
# Anchor stocks	10
# Situations	11
# Turnarounds	5
# New Public Listings	-
# Placements	-
Other Issues	-
Company visits	2
Company presentations	29
New Companies Reviewed	11