

Quarterly Newsletter # 23

Selector Australian Equities Fund



September 2010

In this quarterly edition we review performance and attribution. We examine some risks of merger & acquisition strategies. We discuss Campbell Brothers in detail - a portfolio position. And we make a comment on the changing world order.

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About Selector

We are a boutique fund manager and we have a combined experience of over 60 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.

When we arrive at work each day we are reminded that;

“The art of successful investment is the patient investor taking money from the impatient investor”.

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,

“The only people still buying equities are the fund managers that have to because it’s part of their mandate, says the Royal Bank of Scotland’s global head of equities” as reported in the Australian Financial Review on 20 September 2010 under the heading – *Funeral song for the shares theory*. The sombre picture painted by RBS reflects the general hesitation felt by most share investors. And as a consequence cash remains firmly parked on the sideline.

A few days later, the Australian newspaper’s James Dunn noted that “Investors will have to adjust to a more volatile market. Volatility has always existed on the share market, but it has never been as starkly confronting to investors as it has been during the past two years.” Our take is that volatility appears to be a concern when things are going down but less so when things are on the rise. We believe that investors will continue to focus on these concerns until equity returns have clearly outpaced those of cash deposits.

These views are not new. They simply reflect the current mood as shaped by the recent traumatic period. In truth there is no right or wrong, but when combined they help to give an appreciation that things are less than perfect. And herein lays the opportunity to track down genuine investment opportunities when others remain reluctant.

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This quarter our lead article is titled -The year of living dangerously - where we highlight the growing risk that mergers and acquisitions may present to unsuspecting investors. Following this we profile Campbell Brothers, a new investment that was added to the portfolio and in our final article headed – The changing world order – we take a peek at the shift in economic activity among the world’s leading nations.

Finally, we are pleased to report a solid performance number for the September quarter of 2010, with the Fund’s portfolio value rising 6.55% (refer portfolio statistics page 25). We trust you enjoy this latest quarterly report and look with confidence to the year ahead.

Regards

Tony Scenna
Victor Gomes
Corey Vincent



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Performance September Quarter 2010

For the September quarter 2010, the Fund delivered a net gain of 6.55% against an 8.68% rise in the All Ordinaries Accumulation Index. Performance statistics are detailed on page 25.

Performance table since inception – net returns after all fees

% Returns	Fund %	AOAI %	Difference %
3 months	6.55	8.68	-2.13
1 year	2.39	1.73	+0.66
2 years	5.17	4.53	+0.64
Since inception compound pa	6.44	7.14	-0.70

Top 10 September 2010*	Top 10 June 2010*
Blackmores	Cochlear
Cochlear	Flight Centre
Flight Centre	IOOF Holdings
IOOF Holdings	IRESS Market Technology
IRESS Market Technology	News Corporation
Pharmaxis	Pharmaxis
ResMed Inc.	ResMed Inc.
Seek	Seek
SIRTeX Medical	SIRTeX Medical
Whitehaven Coal	WorleyParsons
Top 10 = 67.9%	Top 10 = 66.3%

*Listed in alphabetical order

Selector runs a high conviction index unaware stock selection investment strategy with typically 15-25 stocks chosen for the Fund. As shown above, the Fund's top 10 positions usually represent the great majority of its equity exposure. Current and past portfolio composition has historically been very unlike that of your average run-of-the-mill "index hugger" fund manager. Our stock selection to this point has not included either retail banks or the large resource companies, RIO and BHP. 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	%
Flight Centre	2.8%	Cochlear	-0.4%
Blackmores	1.1%	ResMed Inc	-0.3%
Whitehaven	1.0%	News Corporation	-0.3%
IOOF Holdings	0.7%	Billabong International	-0.3%
Seek	0.5%	IRESS Market Technology	-0.0%

The strong local dollar is certainly playing havoc among our major exporter players and reflected in the negative contributions to performance during the quarter from the likes of Cochlear, ResMed, News Corporation and Billabong. However, while the impact on profits is not to be lightly dismissed, our main concerns rests with how the businesses are performing and how management deals with the things under their control. On that front, the recent results from all of the above noted companies were pleasing to the eye. Apart from Billabong that is still coming to grips with a benign retail environment, the remaining three are a picture of health with strong business fundamentals and positive future prospects.

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On the positive side of the ledger, Flight Centre and our recently added investment in Blackmores (reviewed in our June 2010 quarterly newsletter) were standout performers. Flight Centre, in particular, is worthy of special mention following the events of 2008. Sheer panic among investors during the global financial crisis, saw the group's share price dive 89% to a new decade low of \$3.39. Despite its healthy balance sheet and an equally impressive earnings record, the market's reaction made little sense to us and we held our ground despite the anguish felt. Roll forward two years and the business is enjoying the fruits of a stronger currency and business changes made during the period.

Table 1: Flight Centre Track Record

	2006	2007	2008	2009	2010	2011(e)
Revenue \$m	974	1,122	1,408	1,474	1,521	1,670
EBIT \$m	111	161	200	89	206	231
NPAT \$m	80	121	143	38	140	162
Income Margin %	11.4	14.3	14.2	6.0	13.5	13.8
ROCE %	42	41	36	14	33	32
Net Cash \$m	43	90	(0.1)	33	144	137

In contrast, Qantas reported a net profit of \$112 million for the 2010 year and is currently valued by the market at \$6 billion in comparison to Flight Centre's \$2.3 billion. For 2011, the group is on a PER of 14 and a fully franked yield of 4.0%. *SFM*

The year of living dangerously

If we were looking to describe the recent past from an investors perspective, 2008 would rank as the year of survival, 2009 the year of revival and 2010 the year of living dangerously.

It is a little over two years ago that global markets were rocked with the collapse of 158-year-old investment bank, Lehman Brothers. Whilst the fallout that followed has been well documented, the economic impacts continue to play out around the world. Closer to home the financial repercussions have been less obvious but that should serve more as a warning of what may have been rather than any accolades for a job well done.

When the music stopped following the Lehman's fallout, highly geared businesses suddenly found themselves without a seat, just like in a game of musical chairs. To make matters worse their former partners, the banks, were the first to leave the party. Many were left fighting for business survival. And with few alternatives they raised an abundance of new capital at precisely the wrong time. In all, investors ploughed over \$100 billion of new capital into our locally listed businesses to ensure survival. And as we noted in our June 2009 quarterly newsletter article titled "Earnings Dilution", investors paid a heavy price through massive earnings dilution.

For those investors who participated in the torrent of new raisings, 2009 proved to be a stellar period. Stock prices zoomed on the back of relief that the world wasn't about to end and were fuelled by the significant share price discounts on offer. Now after the extremes, the reality check facing all investors is where to from here.

The urge to grow

The near and present danger is that constant need to grow. Investors demand it, business boards crave it and investment banks urge it. For those of us with longer memories, the challenge remains – act prudently and proceed with caution. We wrote about these dangers in our March 2010 quarterly newsletter titled "Overpaying for assets", focusing specifically on three companies, Rio Tinto, Wesfarmers and Primary Health Care. While investors from both Rio Tinto and Wesfarmers have prospered with share price gains on newly raised capital of 167% and 153% respectively, the same cannot be said of Primary Health Care. Here shareholders have paid a hefty price. This business is under industry pressure, reflected in a share price fall of around 45%.

So with these comments as a backdrop, we consider the current investment climate. While 2008 is still relatively raw in the minds of most investors, there are clear indications of a mood shift among the investment bankers and company boards. The clear evidence of this shift is in the growing number of corporate marriages currently underway. As Table 2 illustrates, deals are being done across the corporate landscape.

Table 2: Corporate activity scorecard 2010

#	2010	Buyer	Seller	Value
1.	May	Valspar	Wattyl	\$142M
2.	Aug	AP Eagers	Adtrans	\$105M
3.	Jul	Aegis Group plc	Mitchell Communications Group	\$363M
4.	Dec	National Australia Bank	AXA Asia Pacific Holdings	Blocked
5.	Nov	AMP	AXA Asia Pacific Holdings	Failed
6.	May	Campbell Brothers	Ammtec	\$148M
7.	Jul	Aspen Group	Sigma Pharmaceuticals Division	\$900M
8.	Jul	Banpu Minerals	Centennial Coal	\$2,500M
9.	Jul	GrainCorp	AWB	Failed
10.	Aug	Agrium Inc	AWB	\$1,226M
11.	May	GUD Holdings	Dexion	\$84M
12.	Sep	Anatolia Minerals	Avoca Resources	\$916M
13.	Sep	Goldcorp Inc	Andean Resources	\$3,760M
14.	Sep	Private Equity	Foster's Group Wine Division	\$2,300 - \$2,700M
15.	Sep	Archer Capital	Keycorp	\$47M
16.	Mar	Newcrest Mining	Lihir Gold	\$9,500M
17.	Jul	Peoplebank	Ross Human Directions	\$58M
18.	Aug	BHP Billiton	Potash Corporation of Saskatchewan	US\$40,000M
19.	Aug	Stockland	Aevum	\$314M
20.	Jun	Billabong International	West 49	\$101M
21.	May	Carlyle Group & TPG	Healthscope	\$1,987M
22.	Aug	Brookfield Infrastructure	Prime Infrastructure	\$1,618M
23.	Sep	Santa Fe Holdings	Wrightways Australia	\$93M
24.	Sep	Dart Energy	Apollo Gas	\$94M
25.	Oct	NIB Holdings	GMHBA	\$140M
26.	Oct	New Hope Corporation	Northern Energy	\$193M
27.	Oct	Kagara	Copper Strike	\$16M

Having “cleaned up” by charging exorbitant fees during the capital raising frenzy of 2009, investment bankers have now turned their attention to the equally lucrative mergers and acquisition space. A consistent theme from management teams during the recent reporting season was the renewed willingness to consider, and interest in pursuing “growth” opportunities being shopped about by investment bankers. And

frankly this shouldn't surprise anyone since it is a reflection of the growing cash pile on balance sheets and the lack of revenue growth in some quarters of the economy. According to Macquarie Equities, Australia's top 200 listed companies had a combined total of more than \$100 billion in cash on hand at June 30 and the lowest level of corporate gearing in 15 years. Even more revealing is the cash hoard taking place in the United States. While governments are struggling under a weight of debt, US companies now have around ten per cent of total assets in cash. And while we haven't seen cash being freely splashed about just yet, all the signs point to renewed corporate activity both locally and abroad.

Closer to home, the institutional imperative to do something is also a point of concern as highlighted by a recent fund manager comment on the subject "I can understand why boards are pretty cautious, but that cannot persist forever. It becomes very dilutive to the overall return and the current state of laziness cannot continue." Such views have a way of driving opinion even though they may be contrary to the long term interest of shareholders.

On the lookout for dumb deals

We are always on the lookout for dumb deals that have the potential to destroy wealth. Our preferences are those businesses that have the ability to organically grow using internally generated cash flow. There are many examples of these true wealth creators, including Cochlear, Blackmores, Reece Australia and ResMed. Over periods of five and ten years these businesses have delivered strong earnings growth and rising dividend streams (excluding ResMed) without the need to undertake company changing acquisitions and dilutive capital raisings. In short, the business moats around these companies have been sufficiently strong and the economic returns have been duly attractive. In combination, they have allowed the managers to grow the business franchise in both a financially responsible and rewarding fashion for shareholders. Table 3 illustrates this point.

Past Successes and failures

We are not trying to suggest that businesses that augment their product or service offering with a well thought out acquisition or even a transformational deal is without merit. As an example, several businesses owned by the Fund, have undertaken bolt on acquisitions. The list includes surf and sports apparel group Billabong International (reviewed December 2008 quarterly newsletter), analytical testing provider Campbell Brothers (see review below), IRESS Market Technology (reviewed March 2010 quarterly newsletter) project infrastructure and engineering design company WorleyParsons (reviewed March 2009 quarterly newsletter) and financial services and data operators IOOF.

Table 3: Company comparison

Company	Today	5 Years	10 Years
Blackmores			
Revenue \$m	214.9	134.4	79.6
EBIT \$m	36.7	17.4	8.7
NPAT \$m	24.3	11.7	5.4
EPS ¢	146.8	74.0	36.2
DPS ¢	112.0	58.0	33.0
Share Price \$	22.30	12.95	5.80
Cochlear			
Revenue \$m	734.8	349.0	144.2
EBIT \$m	220.5	82.5	30.4
NPAT \$m	155.2	59.6	20.2
EPS ¢	275.7	112.4	39.6
DPS ¢	200.0	80.0	30.0
Share Price \$	74.32	39.20	28.76
Reece Australia			
Revenue \$m	1,503.5	1,009.6	593.6
EBIT \$m	163.6	108.5	60.5
NPAT \$m	114.3	75.3	38.8
EPS ¢	115.0	76.0	39.0
DPS ¢	58.0	38.0	25.0
Share Price \$	24.20	12.90	3.55
ResMed			
Revenue \$USm	1,092.4	425.5	115.6
EBIT \$USm	240.4	97.4	33.1
NPAT \$USm	190.1	64.8	22.1
EPS ¢	252.0	94.0	69.0
DPS ¢	-	-	-
Share Price \$US	60.81	33.00	19.59

Each company has successfully executed acquisition strategies despite the sometimes painful process to bring it together. When a big opportunity “too good to pass” comes along and management says yes, that’s when you hold your breath as an investor. A case in point is blood group CSL’s acquisition in 2000 of global plasma manufacturer ZLB for an initial capital outlay of \$890 million. In undertaking the deal, CSL issued \$300 million of new capital at an adjusted share split price of \$7.33 per share (\$22 pre-share split). Not only was this an offshore acquisition with all the risks

inherent in such a move, it was also large in the context of the group's existing market capitalisation of \$3.3 billion. The group augmented this purchase in 2003 with the buyout of the world's second largest plasma player Aventis Behring for an initial upfront payment of \$786 million.

Today the combined division of ZLB Behring, renamed CSL Behring, contributes almost 80% of group earnings, namely \$3.5 billion of revenue and \$1.1 billion of earnings before interest and tax (EBIT). All in all management have been vindicated with their purchases and shareholders have reaped the rewards with the share price now trading at \$31.85 per share (\$95.55 pre-share split).

In stark contrast stands the Foster's Group. The Fund has no investment in this business even though the group's beer business remains a standout quality asset. Unfortunately a series of dumb decisions to invest in a capital intensive industry, generating low returns on capital employed has been its undoing. In all, Foster's management has presided over a great deal of heartache, some \$3.8 billion to be exact. Wine acquisitions including Mildara Blass for \$428 million, US based Beringer Wines for \$2.9 billion and the top of the market buyout of Southcorp for \$3.7 billion, now collectively sit on the company's books at just \$3.2 billion. Today private equity has sniffed the opportunity. A low ball bid of \$2.3 billion - \$2.7 billion for the group's wine assets will test the mettle of the board. So far management has resisted. And as such there remains hope that having bought at the top they won't compound the situation by selling at the bottom. Time will tell.

BHP pursuing growth

Enter BHP Billiton and its pursuit of long life, world class resource deposits. Its failure to get Rio Tinto across the line with its \$140 per share cash and scrip bid in 2008 may have been a blessing in disguise. Having dodged that bullet, BHP sailed through the global crisis and now finds itself in an impeccably strong financial position.

With China's demand for resources remaining strong, cash is building fast. And one thing is clear, CEO Marius Kloppers isn't about to return large amounts of cash to shareholders, preferring instead to spend the growing pile to expand the group's resource base.

So management has set its sights on Canadian fertilizer group Potash Corporation of Saskatchewan with a US\$40 billion cash bid. The offer has been well and truly rebuked by Potash management. BHP can walk away or up the ante. Yet the price Kloppers has offered is already generous, placing the target on an earnings before interest, tax, depreciation and amortisation (EBITDA) multiple of 11.4x in comparison to BHP's own current valuation of 7.0x. Paying a fair price for an asset is one thing but the risk of paying a top price when your

own shares are trading at a discount is tempting fate or ultimately doing shareholders a great disservice.

Understanding what your business is worth

Warren Buffett picked up on this point in the 2009 Berkshire Hathaway Inc. annual report commentary to shareholders. In one section headed "An Inconvenient Truth", Buffett zeroed in on the group's own distaste in issuing shares to complete mergers,

"Charlie and I enjoy issuing Berkshire stock as much as we relish prepping for a colonoscopy. The reason for our distaste is simple, if we wouldn't dream of selling Berkshire in its entirety at the current market price, why in the world should we sell a significant part of the company at the same inadequate price by issuing our stock in a merger?"

In BHP Billiton's case the board is opting to pay for the Potash acquisition in cash so its long term impact on shareholders is less than if BHP shares were used as consideration. Too often shareholders are asked to pay for a business using their own scrip. The trouble with this as Buffett continued,

"If shares of a prospective acquirer are selling below their intrinsic value, it's impossible for that buyer to make a sensible deal in an all-stock deal. You simply can't exchange an undervalued stock for a fully-valued one without hurting your shareholders.....if an acquirer's stock is overvalued, it's a different story."

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Watch out for Investment Bankers

This leads us back to those investment bankers hankering for a deal. Too often touted as being in the best interests of shareholders, Buffett has a sensible solution to provide some protection to existing shareholders,

"When stock is the currency being completed in an acquisition and when directors are hearing from an advisor, it appears to me that there is only one way to get a rational and balanced discussion. Directors should hire a second advisor to make the case against the proposed acquisition, with its fee contingent on the deal not going through. Absent this drastic remedy, our recommendation in respect to the use of advisors remains, don't ask the barber whether you need a haircut."

They say that time heals all things. Well two years on since the financial collapse of 2008, we think it is only a matter of time before bankers start splashing that money around and when they do, watch out. Already the list of corporate deals is long and likely to grow further. Shareholders need to remain vigilant because acquisitions sold as a win-win situation, rarely are. **SFM**

Campbell Brothers (CPB)

Table 4: Campbell Brothers Corporate History 1863 - 2010

Year	Event
1863	Company starts business life as a soap maker.
1952	Campbell Brothers lists on the Australian Stock Exchange, growing into a leading diversified services company covering analytical laboratory services, specialty chemicals and distributor of hospitality products.
1998	NPAT exceeds \$10M for first time on revenue of \$175M.
1999	ALS acquires Chemex Laboratory Group for \$8M, with operations in Canada, USA, Mexico and Peru, making ALS the single largest minerals analysis group in the world.
2000	Company sells its soap business to Faulding Healthcare for \$4.6M in December.
2001	Jan – ALS acquires Canada’s leading environmental analysis group Analytical Services Laboratories established in 1982 for \$10M.
2005	NPAT hits \$21.9M on revenues of \$436M.
2005	CEO Bruce Brown retires following 15 years as CEO and 36 years since joining company in 1969.
2005	Greg Kilmister appointed new CEO, General Manager and employee of ALS since 1992 and 1981 respectively.
2005	Company announces 1:5 rights issue at \$9.00 per share, raising \$75M to fund growth initiatives.
2006	Jan – Acquires Enviro-Test Laboratory Group, Canada’s second largest environmental testing group for \$57M, pushing annual North America laboratory revenues to in excess of \$125M and global revenues to \$300M supported by 58 laboratories.
2006	Acquires Swedish based laboratory group Analytica AB for initial cash payment of \$25M.
2006	Acquires two laboratory acquisitions based in Melbourne (Consulchem) and West Africa (Abilab) for \$11M in cash.
2006	Dec – Company sells Home Services Division to Rentokil for \$48M.
2007	Company sells out of listed coal analytical services group CCI Holdings following takeover rejection.
2007	Sep – Enters environmental market acquiring US environmental laboratory group e-Lab Analytical Inc for \$18M.
2007	Company acquires Australian coal services company ACIRL for \$76.8M, employing 400 people and market leader in coal testing with approximately 46% market share.
2007	Company posts NPAT of \$59M on revenues of \$663M, market capitalisation exceeds \$1.5B.
2008	Company shares hit all time high of \$36.36 per share during September 2008.
2009	Company shares hit multi-year low of \$8.29 per share during March 2009.
2009	Company reports record NPAT during 2009 of \$106M on revenues of \$920M.
2009	Takeover of PearlStreet, Australia’s largest non-destructive testing services provider for \$64M in cash.
2009	Company launches 1:6 renounceable rights issue @ \$22 per share to raise \$196.6M.
2010	Group NPAT falls 29% to \$75M, recording its first drop in earnings since 2002.
2010	Company bids for listed mineral testing consultancy group Ammtec, finally gaining approval with cash / scrip offer valuing business at \$148M.
2010	Company employs over 8,000 staff, operating in 200 plus sites in 44 countries. The group’s market capitalisation now sits at \$2.1B, with revenues in excess of \$1.0B.

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Table 5: Campbell Brothers Financial Snapshot

\$'M	1995	2000	2005	2006	2007	2008	2009	2010	2011e
Revenue	97.1	271.7	435.6	485.5	611.2	761.0	920.4	825.5	1040
Operating Expenses	89.9	250.3	349.6	432.5	402.5	652.1	756.8	710.2	855.0
EBIT	7.2	21.4	40.9	53.0	83.0	108.9	163.6	115.3	185.0
NPAT	4.7	12.1	21.9	32.7	50.9	76.0	106.2	74.9	126.0
EBIT Margins (%)	7.4	7.9	9.4	10.9	13.6	14.3	17.8	14.0	17.8
Shareholders' Equity	30.5	88.6	151.1	256.7	299.5	338.2	413.1	629.7	675.0
Net Debt / (net cash)	18.4	48.2	73.2	85.7	88.9	191.5	209.6	147.0	127.0
Market Capitalisation	47.0	125.1	366.1	886.4	1,436.0	1,364.5	1,052.6	1,914.5	2,076.4
Enterprise Value	65.4	173.3	439.3	972.1	1,524.9	1,556.0	1,262.2	2,061.5	2,203.4
Buyout (%) **	11.0	12.3	9.3	5.5	5.4	7.0	13.0	5.6	8.4
ROCE (%) *	15.0	15.6	18.2	15.5	21.4	20.6	26.3	14.8	23.1
GOCF / EBITDA (%)	85	44	95	97	85	85	58	93	95
Underlying EPS (¢)	27.2	39.0	53.8	76.8	114.6	147.8	201.9	119.0	198.0
PER	9.9	10.4	16.3	22.6	24.3	17.7	9.8	25.3	16.5
Dividend per share (¢)	16.0	27.0	42.0	50.0	70.0	95.0	100.0	100.0	130.0
Dividend Yield %	5.9	6.7	4.8	2.9	2.5	3.6	5.0	3.3	4.0
Share Price 30 June (\$)	2.70	4.05	8.78	17.38	27.83	26.19	19.86	30.15	32.70
Issued shares (m)	17.4	30.9	41.7	51.0	51.6	52.1	53.0	63.5	63.5

* ROCE = EBIT / (Shareholders Equity + debt – cash)

** Buyout represents EBIT / EV as a percentage

History

There are few listed Australian companies that have a history that dates back to the ninetieth century but in the case of Campbell Brothers, its origins can be traced to 1863 when it began life as a soap maker. The foundations were laid by Peter Morrison Campbell and later extended by son's Norman Carlisle and Ronald Clifford in 1910, leading to the formation of private company Campbell Brothers. In 1923 the business separated into three areas, household soap, toilet soap and chemicals, attracting the interests of competitor Kitchen & Son (now Lever & Kitchen) in 1924 with an offer to buy the business for 12,500 pounds. The offer was rejected and led

to the company ultimately listing on the Brisbane stock exchange in 1952, selling shares in lots of 100 shares for 25 pounds.

In 2010 the company celebrated its one hundredth year anniversary and its fifty-eighth year since listing. Today, Campbell Brothers is a vastly different business. While it has maintained some link to its past, the change has become more pronounced in recent years. First time visitors to the group’s website may mistakenly compare the company’s logo to the Australian Coat of Arms, a relic of years gone by.

In 2000, the original soap business was sold to Faulding Healthcare for \$4.6 million, as the business expanded further into industrial chemical operations and consumer products. Today, Campbell Brothers describes itself as an Australian diversified industrial services company with operations around the globe.

Campbell Brothers Logo



At the operational level, the business is broken into three areas with the Campbell Chemicals and Rewards Distribution divisions’ small contributors to group profits and revenues while the laboratory testing services subsidiary ALS Laboratory Group remains the prime contributor as illustrated by Graph 1.

Graph 1: Campbell Brothers divisional contributors



Table 6: Divisional Contribution

\$'M	2003	2004	2005	2006	2007	2008	2009	2010
Revenue								
ALS Laboratory Group	114.4	123.9	159.2	208.9	342.2	468.0	628.8	561.6
Campbell Chemicals	132.1	127.9	124.1	167.1	163.9	152.8	164.3	151.8
Reward Distribution	115.5	141.5	154.1	112.0	135.0	145.7	132.8	117.8
Total	362.0	393.3	437.4	488.0	641.1	766.5	925.9	831.2
Operating Profit								
ALS Laboratory Group	16.3	21.5	35.6	47.3	79.5	112.5	155.8	118.0
Campbell Chemicals	5.9	5.2	6.6	9.5	8.2	9.7	7.9	8.2
Reward Distribution	7.9	9.3	8.3	5.9	5.5	4.6	3.4	3.4
Total	30.1	36.0	50.5	62.7	93.2	126.8	167.1	129.6
Operating Margins %								
ALS Laboratory Group	14.2	17.4	22.4	22.6	23.2	24.0	24.8	21.0
Campbell Chemicals	4.5	4.1	5.3	5.7	5.0	6.3	4.8	5.4
Reward Distribution	6.8	6.6	5.4	5.3	4.1	3.2	2.6	2.9
Total	8.3	9.2	11.5	12.8	14.5	16.5	18.0	15.6

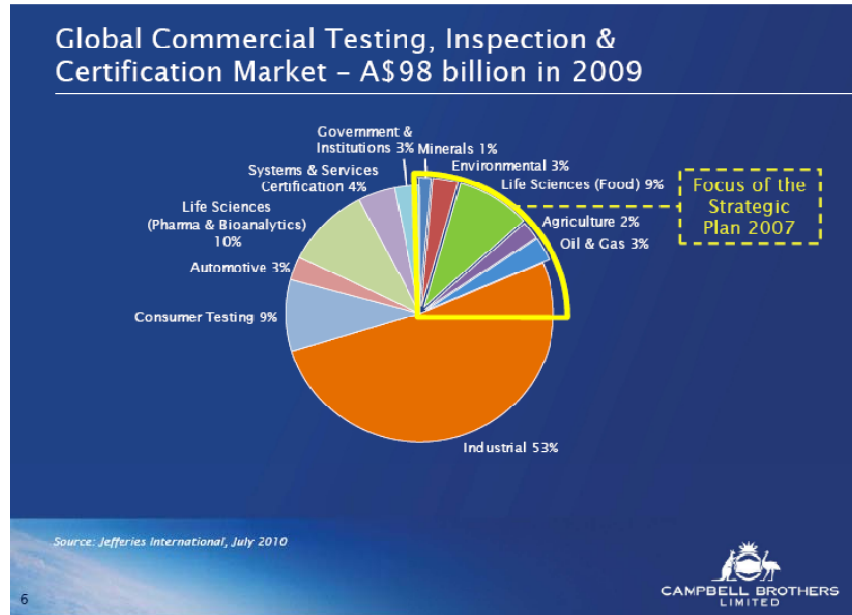
As Table 6 highlights, the mainstay of revenue and profit growth has fallen to the group's analytical laboratory testing division ALS Laboratory. In short, ALS has successfully exploited a market to test and certify product supplies from a raft of customers in key industries including;

- i. minerals - specifically gold, nickel and now coal,
- ii. environmental - surrounding analysis of soil, water and air quality,
- iii. tribology - being the analysis of lubricating oil from mechanical equipment and
- iv. industrial - analysis of assets including plant inspection, power generation and infrastructure assets.

Management identified the laboratory testing market as a key strategic objective for the group earlier this decade. Putting numbers to the opportunity set is a worthwhile exercise but not always a reliable indicator. That said, it is estimated that the global commercial testing, inspection and certification market is worth \$98 billion, of which

Campbell Brothers is currently targeting one quarter of the pie, specifically relating to the testing market as denoted by Graph 2.

Graph 2: Global Commercial Testing, Inspection & Certification Market



To date their approach has been to gain a foothold in a given testing field, usually by acquisition and then seek to grow organically.

It is a strategy that has worked very well for another serial acquirer, the QBE Insurance group and one that has so far delivered excellent results for Campbell's. Specifically, the group has added over fifteen acquisitions during the past decade and spent in excess of \$300 million since 2006, a figure that is set to rise by another \$150 million once the current bid for listed Australian mineral testing group Ammtec is completed.

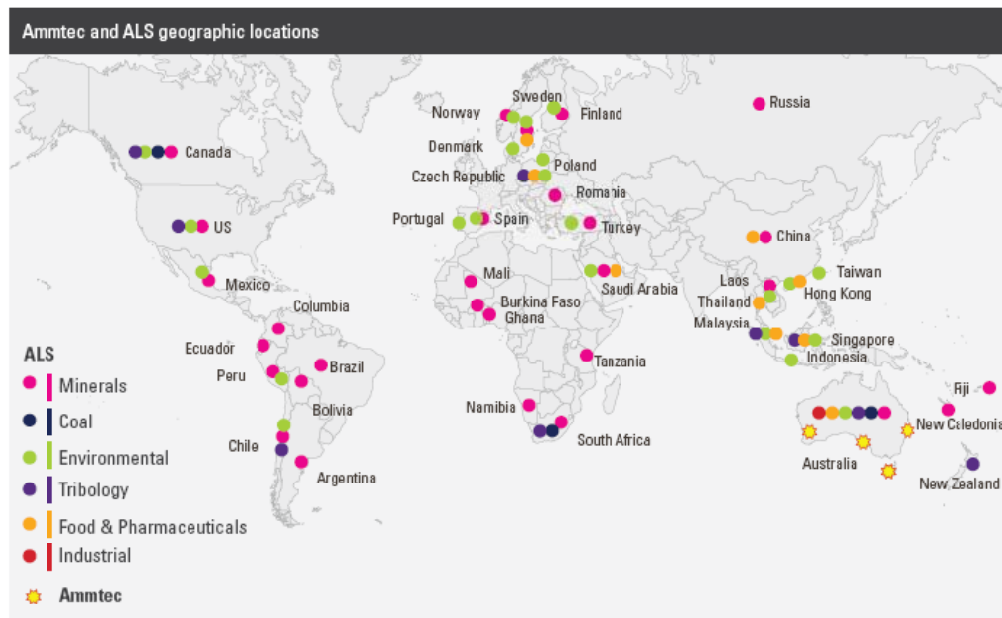
As we noted in our earlier piece, acquisitions can cause considerable pain particularly when the numbers are big. However management have so far avoided many of the pitfalls that beset new owners and have largely paid for the bulk of the acquisitions with cash, thus limiting shareholder dilution as we will discuss a little further on.

At its core the ALS Laboratory service offering is built around the need to test things. For example mineral companies need to test mining samples to confirm their quality or grade and to ensure a specific shipment of product is sent to the right customer.

Similarly, testing for environmental issues ensures standards are maintained while regular plant inspections can pinpoint problems before they emerge. While companies can undertake these services in-house the great bulk of work is carried out by external groups like Campbell Brothers. More importantly, because of the large volume of tests required, providing scale and global coverage becomes an important point of service differentiation.

On this score management is only too happy to point out that the ALS Group is “one of the largest commercial laboratory groups in the world – arguably the most successful commercial analytical laboratory in the world.” With over 160 labs in 42 countries, ALS operates under what is commonly termed a hub and spoke model, whereby a large number of smaller sized labs service larger hub laboratories. And it is a competitive edge that the group has exploited. Where competitors struggle to transfer testing samples internationally, ALS’s information system, dubbed Laboratory Information Management System (LIMS), enables sample tracking and online web-based interaction with clients.

Graph: 3 ALS global operations



Source: Campbell Brothers website; Ammtec website

To date, the returns generated on capital invested have justified management’s faith in the industry but to be frank, the tailwind that has been the resources bull market has certainly helped things along. During 2010, ALS suffered a setback to revenue

and earnings as the financial crisis took hold and testing volumes dropped. Profits fell 24% to \$118M on revenues down 11% to \$562M, while margins held up reasonably well at 21%.

To provide some earnings shelter, management has sought to broaden its service offering moving aggressively into a number of new markets with reasonable success as highlighted in Table 7.

Table 7: ALS Laboratory Group Contribution

\$'M	2010	2009
Revenue		
ALS Minerals	205.0	310.8
ALS Environmental	245.2	234.9
ALS Coal	61.8	59.2
ALS Tribology	29.8	23.9
ALS Industrial	19.8	0.0
Total ALS	561.6	628.8
Operating Profit		
ALS Minerals	53.3	112.2
ALS Environmental	43.8	28.4
ALS Coal	15.0	13.2
ALS Tribology	4.6	2.1
ALS Industrial	1.3	0.0
Total ALS	118.0	155.9
Margins %		
ALS Minerals	26.0	36.1
ALS Environmental	17.9	12.1
ALS Coal	24.3	22.3
ALS Tribology	15.4	8.8
ALS Industrial	6.6	0.0
Total ALS	21.0	24.8

Of these, ALS Minerals is the division's largest earnings contributor at about 45%, with the bulk of these profits, estimated at 40%, coming from the North American operations followed by Australia and South America. Likewise, ALS Environmental, covering the analysis of soil, water and air quality is split along similar lines although the group's recent Ecowise acquisition in Australia should see the earnings contributions more evenly matched in future years.

ALS Coal is in its infancy, following the 2008 acquisition of ACIRL in Australia and Wittab in South Africa, however the group is already market leader locally and building up scale in both South Africa and Canada. The newer divisions of Tribology and Industrial are small in revenue and profit terms but will benefit from another recent acquisition PearlStreet.

Globally, Campbell Brothers is relatively small compared to its peers (see Table 8) that include the big compliance testing groups SGS, Interlek, Bureau Vertias and smaller oil and gas specialty player Core Labs. Yet despite this, management have successfully positioned the group to dominate in key markets such as Minerals where it has the largest market share and Environmental, where it sits at number two. It is aiming to develop its ALS Coal division into a leading position, having made significant inroads over the past two years.

Table 8: Global competitive landscape

Global Players	Listed	Revenue	Operating Profits	Market Cap	EV/EBIT* 2011(e)	Employees	Laboratories
SGS	Switzerland	CHF 4,712 m	CHF821 m	CHF12.6 b	14.0	59,000	1,000
Intertek	United Kingdom	£ 1,237 m	£ 187 m	£ 2.9 b	13.4	26,000	1,000
Bureau Veritas	France	€ 2,648 m	€ 433 m	€ 5.5 b	11.8	39,000	900
Core Labs	United States	\$US 696 m	\$US 187 m	\$US 3.9 b	15.2	4,900	50
Campbell Brothers	Australia	\$A 825 m	\$A 118 m	\$2.1 b	11.9	8,000	200

* EV/EBIT = Enterprise Value / Group EBIT

Management

And being big doesn't count for much if you have little to show for it. In the case of Campbell's, there is a lot to like and importantly it starts at the very top with management. Former CEO Bruce Brown, an employee of the group for 30 years until his retirement in 2005, certainly deserves a lot of the credit during his 15 year reign as leader. The building blocks of the business were set and maintained during his watch and extended when the baton passed to another long time employee Greg

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Kilmister. He brings continuity to the table as well as a 29 year association with the business including 13 years as General Manager of the all important ALS Laboratory division, until his main appointment in 2005.

Campbell Brothers CEO's Past & Present



CEO Bruce Brown
1990 - 2005



CEO Greg Kilmister
2005 – Present

As noted earlier, the group has spent up big under Kilmister's watch, adding scale and grunt to the testing services division. This has not been without risk but shareholders have been well looked after during the past 15 years as highlighted in Table 5.

19

Strong financial record

Since 1995, group revenues and profits have soared, while margins have doubled as the higher earning ALS division surpassed the more sedate chemicals and hospitality operations. Despite the 2010 earnings setback, return on capital employed still stands at a healthy 15% while dividends per share have compounded at 13% per annum. While this is less than the 20% growth recorded in earnings before interest and tax, shareholders have been offered first option to contribute additional capital into the business. The group's issued capital has increased from 17.4 million shares in 1995 to the current 63.5 million and although up, is significantly less than what would have been the case if management had issued shares rather than pay cash for the majority of its acquisitions.

The group's free cash flow pre-acquisitions and before the payment of dividends has been positive and rising since 2003, despite the 2010 set back as shown in Table 9. However, the group's acquisition strategy has impacted the cash flow that remains after the payment of dividends. In this respect the free cash flow post dividend payments has remained largely in the red since 2003, being funded by debt or new equity issues. Obviously, management is confident that the money is being well

spent and while we are prepared to back them in this regard we are mindful of the dangers when a company over commits to such a strategy.

Table 9: Free Cash Flow

\$'M	2003	2004	2005	2006	2007	2008	2009	2010
Free Cash Flow								
Net Operating Cash Flow	29.1	26.0	30.2	46.8	58.3	80.7	167.6	100.7
Normal Capital Expenditure	(12.6)	(11.9)	(17.7)	(26.8)	(39.1)	(50.1)	(71.5)	(43.2)
Free Cash Flow (pre acq & divs)	16.5	14.1	12.5	20.0	19.2	30.6	96.1	57.5
Acquisitions & Asset Sales	(8.1)	(12.9)	18.9	(82.0)	(3.5)	(96.3)	(45.2)	(119.1)
Free Cash Flow (pre dividends)	8.4	1.2	31.4	(62.0)	15.7	(65.7)	50.9	(61.6)
Dividends paid	(9.7)	(9.2)	(10.5)	(14.3)	(18.8)	(25.0)	(37.6)	(32.8)
Free Cash Flow (post dividends)	(1.3)	(8.0)	20.9	(76.3)	(3.1)	(90.7)	13.3	(94.4)

Despite these concerns the company has earned the respect of the market with the company's shares often selling at a premium, along with a market capitalisation now topping \$2.1 billion, placing it within reach of the Australian Stock Exchange top 100. Having firmly committed itself to the global laboratory testing market, the company faces a number of headwinds including a business subject to cyclical demand swings and a growing offshore earnings profile. The strong Australian dollar certainly makes life harder in this respect as does the need to sustain increasing levels of testing volumes to cover overheads.

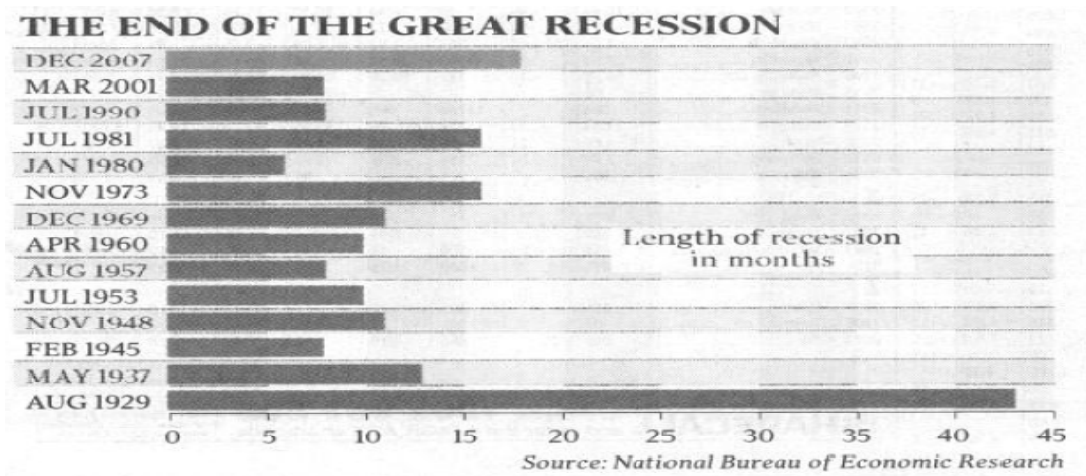
During the past quarter we added Campbell Brothers to the portfolio, making up 2.5% of the Fund's value at an entry price of \$30.94 per share. Based on our entry price, the investment is trading on a prospective PER of 15.6 and a partly franked yield of 4.2%.

In our June 2010 quarterly newsletter we highlighted our investment in Blackmores, noting that there was a lot to like about the business but none more so than the reputation earned over seventy years. In a similar vein, the Campbell Brothers business has morphed over the past century but its reputation earned both in business and from shareholders is clearly deserved. *SFM*

The changing world order

According to the US National Bureau of Economic Research’s Business Cycle Dating Committee – a group of academic economists that determines the widely accepted benchmarks for US recessions – the US recession is over. A fact reported by the Wall Street Journal on 22 September,

“It’s official: the 2007-09 recession, which wiped out 7.3 million US jobs, cut 41 per cent from economic output and cost Americans 21 per cent of their net worth, marked the longest slump since the great depression.



While that may cheer many who follow statistics, the long term legacy issues flowing from this recession are still being felt. According to the Centre for Economics and Business Research (CEBR),

“The financial crisis will accelerate the shift of economic power to emerging economies as their recovery outpaces that of developed countries. Nations in the Organisation for Economic Cooperation and Development (OECD) will account for 66 per cent of the world’s gross domestic power by 2015, compared with 77 per cent in 2004.

The OECD consists of 33 countries namely; Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israël, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States. CEBR economists Owen James comments further on the changing world order,

“For western economies, the outlook over the next five years is certainly that of a hard slog. The focus of global economic activity will shift increasingly to countries like China, India, Russia and Brazil and to a lesser extent Mexico, Canada and Australia.

The U.S’s share of the global economy will fall to 22.6 percent in 2015 from 25.3 percent in 2007, while the U.K’s will drop to 3.3 percent from 4 percent. Germany’s share will slip to 5.3 percent from 6.1 per cent. China’s share of the world economy will jump to 11.4 percent from 7 percent, and India’s contribution will grow to 2.9 percent from 1.9 percent. India will overtake Russia, Canada and Spain in size by 2013.”

As to the ramifications for Australia, Geoff Raby, an economist by training and Australia’s ambassador to China noted that,

*“For several years, China has been Australia’s largest two-way trading partner. In 2009-10, our total trade increased by 15 percent to \$85 billion. It is tipped to soar beyond \$100 billion by next year, and in 2009, for the first time, China overtook Japan to also become Australia’s single-biggest export market. It is hard to see a set of circumstances in the future under which China will ever be replaced as Australia’s No 1 market. So last year marked a real water-shed not only in Australia-China relations but also in Australian history.” **SFM***

Company visit diary September Quarter 2010
July

WOW	Woolworths results conference call	21/07/10
CNA	Coal & Allied results conference call	29/07/10

August

NVT	Navitas results briefing	03/08/10
NWS	News Corp 4th quarter conference call	05/08/10
TAH	Tabcorp Holdings FY10 results conference call	05/08/10
RMD	ResMed 4th quarter conference call	06/08/10
BHP	BHP Billiton conference call	06/08/10
CXD	CathRx management meeting	09/08/10
COH	Cochlear FY10 results briefing	10/08/10
CBA	Commonwealth Bank of Australia FY10 results briefing	11/08/10
TLS	Telstra Corporation FY10 results briefing	12/08/10
PXS	Pharmaxis management meeting	13/08/10
SAI	SAI Global FY10 results briefing	17/08/10
PRY	Primary Health Care FY10 results briefing	17/08/10
MND	Monadelphous Group FY10 results briefing	17/08/10
CSL	CSL FY10 results briefing	18/08/10
WPL	Woodside Petroleum FY10 results briefing	18/08/10
CRZ	Carsales.com FY10 results briefing	19/08/10
ASX	ASX FY10 results briefing	19/08/10
QBE	QBE Insurance Group HY10 results briefing	19/08/10
BKL	Blackmores FY10 results briefing	20/08/10
BBG	Billabong International FY10 results briefing	20/08/10
PTM	Platinum Asset Management FY10 results briefing	20/08/10
REA	REA Group FY10 results briefing	23/08/10
NHF	NIB Holdings FY10 results briefing	23/08/10
FAN	Fantastic Holdings FY10 results briefing	23/08/10
ALL	Aristocrat Leisure HY10 results briefing	24/08/10
PPT	Perpetual FY10 results briefing	24/08/10
SEK	Seek FY10 results briefing	24/08/10
FLT	Flight Centre FY10 results briefing	24/08/10
IRE	IRESS Market technology FY10 results briefing	25/08/10
WOR	WorleyParsons FY10 results briefing	25/08/10
BHP	BHP Billiton FY10 results briefing	25/08/10
WHC	Whitehaven Coal FY10 results briefing	26/08/10
IFL	IOOF FY10 results briefing	26/08/10

TSE	Transfield Services FY10 results briefing	26/08/10
BBG	Billabong International investor open day	30/08/10
SLM	Salmat FY10 results briefing	31/08/10

September

MYS	Mystate FY10 results briefing	03/09/10
ARP	ARB Corporation FY10 management meeting	09/09/10
MND	Monadelphous Group FY10 management meeting	10/09/10
CAB	Cabcharge Australia management site visit	14/09/10
LCT	Living Cell Technology management meeting	14/09/10
NHC	New Hope Corporation management meeting	22/09/10
GNJ	Gujarat NRE Coal management meeting	22/09/10
CRX	CathRx management meeting	23/09/10
BKW	Brickworks FY10 results briefing	24/09/10
TLS	Telstra open day briefing	29/09/10
QRX	QRXPharma briefing	29/09/10

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The Directors and our associates take no responsibility for error or omission; however all care is taken in preparing this document.

The Directors and our associates may hold units in the fund and may hold investments in individual companies mentioned in this document. *SFM*

FUND REPORT as at 30 September 2010

Issued by DDH Graham Limited ABN 28 010 639 219, AFSL 226 319. The investment information in this Fund report is historical and refers to the period to 30 September 2010. Past performance is not an indicator of future performance for this fund.

PERFORMANCE SUMMARY

	Compound Annual Return						
	3 months (%)	6 months (%)	1 Year (%)	2 Year (%)	3 Year (%)	5 Year (%)	Inception ¹ (%)
Total	6.55	-5.87	2.39	5.17	-9.85	0.34	6.44
Distribution	0.00	0.00	0.00	1.11	1.01	1.41	1.58
Growth	6.55	-5.87	2.39	4.06	-10.86	-1.07	3.82
S&P/ ASX All Ordinaries Accumulation Index	8.68	-3.31	1.73	4.53	-7.09	4.47	7.14

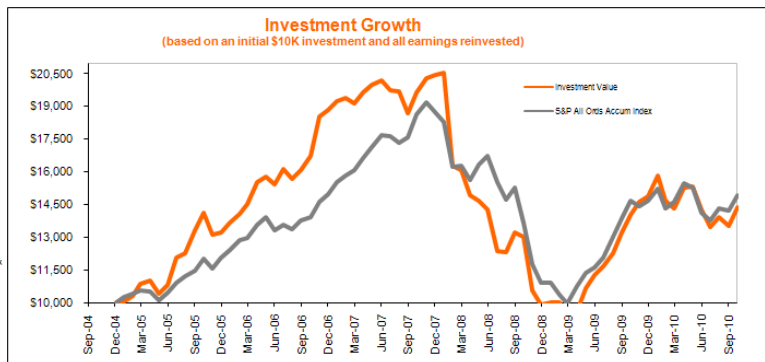
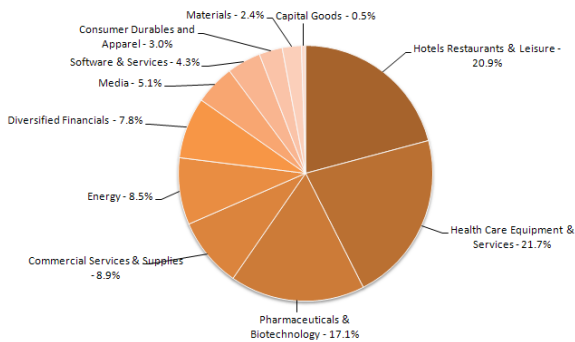
Returns are calculated using exit prices, and are calculated after all fees have been deducted with distributions included and no allowance made for tax. The 'distribution' component represents the amount paid by way of distribution, including net realised capital gains.

1. Inception date - 7 December 2004

MONTHLY DETAIL (past 12 months)

Month ending	Exit Price (\$)	Distribution per Unit (\$)	Month Gain (%) Fund	Compound Inception Gain (% pa) Fund	Index Level	Month Gain (%) Index	Compound Inception Gain (% pa) Index
30 Sep 10	1.3173	-	6.26	6.44	33,056	5.02	7.14
31 Aug 10	1.2397	-	-2.65	5.41	31,476	-0.71	6.34
31 Jul 10	1.2734	-	3.00	5.99	31,702	4.23	6.57
30 Jun 10	1.2363	-	-5.59	5.53	30,415	-2.60	5.88
31 May 10	1.3095	-	-6.78	6.73	31,229	-7.57	6.49
30 Apr 10	1.4047	-	0.38	8.23	33,785	-1.18	8.16
31 Mar 10	1.3994	-	6.60	8.29	34,188	5.83	8.53
26 Feb 10	1.3127	-	-2.33	7.12	32,304	1.82	7.51
29 Jan 10	1.3440	-	-7.37	7.72	31,727	-5.85	7.25
31 Dec 09	1.4509	-	6.47	9.49	33,698	3.69	8.65
30 Nov 09	1.3627	-	1.78	8.28	32,498	1.94	8.02
30 Oct 09	1.3389	-	4.07	8.04	31,878	-1.89	7.74

Sector Breakdown



To receive a Product Disclosure Statement

Free Call: 1800 226 174, email exec@ddhgraham.com.au or visit the website: www.ddhgraham.com.au

Applications for units can only be made on the application form in the Product Disclosure Statement (PDS) dated 15 October 2004 and Supplementary Product Disclosure Statement (SPDS) dated 1 January 2006. Potential investors should consider the PDS and SPDS before deciding whether to invest in the Fund.

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