SFML Quarterly Newsletter
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In this quarterly edition we review performance and attribution. In our headline stories, we visit the USA. In addition we comment on the reporting season, shorting and the institutional imperative. Photo: "Squirrelling nuts before winter, in NYC."

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About Selector

We are a boutique fund manager with 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.

We seek businesses with leadership qualities, run by competent management teams, underpinned by strong balance sheets and with a focus on capital management.

Dear Investor,

Eventful is one way to describe the events of the past quarter. Talk of our share market hitting 6,000 points soon reversed with Greece, China and our local economy taking centre stage. The never ending saga that is Greece, ended where it began, a bailout plan that no one believes will work. China's seemingly world beating growth rates of 7% plus are now a thing of the past, putting more pressure on a world that is awash with cash but lacking any drivers for sustained economic activity. The U.S. economy, perhaps the one truly bright spot, is making positive progress but concerns linger that this could be impacted by offshore events.

U.S. Federal Reserve Chair, Janet Yellen emphasised this point, failing to lift cash rates from a near zero position held since December 2008, for fear of a further fallout from China's recent market ructions. Closer to home, the institutional imperative that often inflicts the investment community seems to have spread to the political world, with our fifth Prime Minister in five years installed, following a challenge from the Minister for Communications Malcolm Turnbull.

Expectations are high that this move may finally bring some sensibility to the economic challenges our economy now faces. That said, doing what is economically right and following through may still not stand up politically, particularly in light of a hostile Senate and an electorate that has shown a clear desire to avoid unpopular measures, irrespective of their merit.

In this quarterly, we address the increasing power of media and the institutional pressures our businesses constantly face in trying to appease the short and long term needs of shareholders. We provide examples of companies, post the reporting season, which appear to have struck the right balance. Following our recent trip to the U.S. we profile two businesses which are moving in the right direction, aided by management teams clear in their message. Finally, we look to define the role of short sellers.

Despite the market's desire to focus on global events, our company specific approach continues to uncover attractive investment opportunities. To this end, current investor apprehension has only helped to increase the attractiveness of company valuations now on offer. This has allowed us to target and invest in businesses that have leadership qualities, run by competent management teams, underpinned by strong balance sheets and with a focus on capital management.

For the 2015 September quarter the Fund delivered a gross positive return of **5.06%** compared to the All Ordinaries Accumulation Index fall of **5.79%**, an outperformance of **10.85%.**

Regards,

Selector Investment Team

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Quote: "Reminiscences of a Stock Operator"

Fictionalised account of the life of securities trader Jesse Livermore by journalist Edwin Lefevre published in 1923. A great read of which we would highlight the following quote as generally underpinning our investment philosophy.

"It never was my thinking that made the big money for me. It always was my sitting. Got that? My sitting tight! It is no trick at all to be right on the market. You always find lots of early bulls in bull markets and early bears in bear markets. I've known many men who were right at exactly the right time, and began buying or selling stocks when prices were at the very level which should show the greatest profit. And their experience invariably matched mine--that is, they made no real money out of it. Men who can both be right and sit tight are uncommon."

Performance September 2015

For the quarter ending September 2015, the Fund delivered a gross positive return of **5.06%** as compared with the **5.79%** fall in the All Ordinaries Accumulation Index. Performance statistics are detailed on page **42**.

Performance table since inception

Returns	Gross Fund Return %	All Ordinaries Accumulation Index %	All Ordinaries Index %
3 Months	5.06	-5.79	-7.20
6 Months	-3.74	-11.68	-13.70
1 Year	13.33	-0.16	-4.50
3 Years annualised	23.10	9.31	4.71
5 Years annualised	15.30	6.28	1.76
10 Years annualised	7.99	5.37	0.97
Since Inception annualised	11.46	7.13	2.69

Fund's Top 10 holdings

Top 10 September 2015*	Top 10 June 2015*
ALTIUM	ALTIUM
ARISTOCRAT LEISURE	ARISTOCRAT LEISURE
BLACKMORES	CARSALES.COM
CSL	CSL
FLIGHT CENTRE TRAVEL GROUP	FLIGHT CENTRE TRAVEL GROUP
GBST HOLDINGS	GBST HOLDINGS
OZFOREX GROUP	IOOF HOLDINGS
RESMED	RESMED
SEEK	SEEK
SIRTEX MEDICAL	SIRTEX MEDICAL
Top 10: 46.39%	**Top 10: 45.91%**

* *Listed in alphabetical order*

Selector employs a high conviction, index unaware, stock selection investment strategy, which typically targets 15-25 stocks for the Fund. As shown above, the Fund's top 10 positions usually represent a high percentage 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 focused on truly differentiated broad-cap businesses rather than the closet index hugging portfolios offered by most large fund managers.

Performance attribution for the September 2015 quarter

Top 5	Contribution	Bottom 5	Contribution
BLACKMORES	2.83%	INFOMEDIA	-0.89%
ARISTOCRAT LEISURE	0.87%	SEEK	-0.64%
OZFOREX GROUP	0.75%	GBST HOLDINGS	-0.51%
IPROPERTY GROUP	0.67%	COMPUTERSHARE	-0.23%
SIRTEX MEDICAL	0.52%	INTUERI EDUCATION GROUP	-0.18%

Portfolio Commentary

Below we provide brief commentary on some of the larger portfolio moves during the quarter.

Top attribution

1. *Blackmores (ASX: BKL)*

Blackmores' management released the group's 2015 financial year result during the quarter. For the year, sales lifted 36% to $471m, operating profits rose 81% to $72.2m while net profits jumped 83% to $46.6m. Dividends of $2.03 were paid, up from $1.27 per share. The growth and demand for **Blackmores** products coming from China is becoming clearer but while the Asian business appears to have elements of an overnight success story, the time and money **Blackmores** has invested in Asia can be easily lost on some people. Supplementing the strong result out of Asia was the domestic business, growing sales by 13% compared with industry growth of 2%. Two years ago the Australian business faced intense competition and heavy discounting. Management responded with supply chain initiatives to drive efficiencies. Combined with a more stable domestic market, these initiatives are now driving local share gains and margin expansion.

2. Aristocrat Leisure (ASX: ALL)

No significant updates were provided by **Aristocrat** during the period. As we outlined in our June 2015 quarterly newsletter following our visit to the G2E Gaming Conventions in both Macau and Sydney, **Aristocrat's** popular suite of games has allowed the company to build a formidable position in gaming regions around the world. The group's full year results are expected to be released in November.

3. *OzForex Group (ASX: OFX)*

During the quarter, **OzForex**'s new CEO Richard Kimber addressed the market for the first time at the AGM in August. He presented a rebranding strategy and an initiative of refocusing on marketing and technology which the company believes can drive revenue from $100m to $200m over three years. **OzForex** expects earnings to grow faster than revenues as the ramp up in customer transactions through the company's platform are driven beyond the period in which customer acquisition expenses are incurred. A step up in the company's investment in marketing should accelerate this earnings growth in time.

4. iProperty Group (ASX: IPP)

Online property portals operator **iProperty Group** released its half yearly result for 2015 during the quarter. Improving operating metrics and an extension of the group's clear leadership positions in Malaysia, Indonesia, Thailand and Hong Kong as well as accelerating revenue growth is providing the market with confidence that the shift from print to online advertising is underway. Leading Australian operator REA Group also saw fit to lift its ownership in **iProperty** during July from 19.9% to 22.7% while confirming that its Chief Operating Officer has accepted an invitation to join the **iProperty** board.

5. *Sirtex Medical (ASX: SRX)*

Reported record dose sales and strong revenue growth as interventional radiologists increasingly use SIR-Spheres to treat liver cancer patients. Accompanying the release was more clarity about how the company expects the recently released results of the SIRFLOX study to impact uptake and acceptance. The study attempted to determine the efficacy of SIR-Spheres as a first line treatment for liver cancer sufferers. At the moment, treatment is largely limited to the salvage market and successful uptake earlier in the treatment cycle would drive significant dose sales growth. Comments made by "Key Opinion Leaders" in the medical community suggest that the results of the trial warrant an elevation of the device to earlier in the treatment cycle.

Bottom attribution

1. Infomedia (ASX: IFM)

Electronic parts catalogue group **Infomedia** handed down a result which missed on earnings guidance provided only four months before the end of the year. The company also announced that CEO Andrew Pattinson would step down from the top job immediately. **Infomedia** has been a business prone to disappoint but Chairperson Fran Hernon was at pains to explain that there was no crisis, and the business' outlook remains positive. Despite a strong pipeline of sales leads for its services, Hernon has ruled out providing future earnings guidance, apparently having learnt the lesson of trying to forecast the likely timing of lumpy contract wins. The group's upcoming AGM in October is expected to provide greater clarity on a likely CEO successor as well as current business performance.

2. SEEK (ASX: SEK)

Having pre-released the group's 2015 results in June, management disappointed some investors with 2016 guidance that reflected strong top line growth, offset by greater investment driving a flat net profit line. While some would argue that the investment **SEEK** is making in online recruiting strategies is necessary to protect their turf, we view it as a key part of **SEEK's** continued growth profile as well as aiding the group in extending its lead over their competitors.

3. GBST Holdings: (ASX: GBT)

In a similar vein to **SEEK**, **GBST** flagged increased investment and consequently flat profits for the 2016 financial year. **GBST Holdings'** management team have been very clear that the investment is appropriate given the continuing success being generated from the UK Wealth Management sector as well as market opportunities in Asia and the US. The company has previously shown prudence and discipline with their budgeting and capital allocation initiatives which provides us with a level of comfort regarding the long term outlook for this business.

4. Computershare (ASX: CPU)

Computershare announced their results for the 2015 year during the period. The company reports their earnings in US Dollars and consequently was negatively impacted by adverse movements in the US Dollar as well as declining yields on client fund balances. To date, **Computershare** has done a very good job of managing costs in a difficult environment, however, the company's 2016 outlook statement also indicated that profits were likely to fall by approximately 7.5% from the 2015 level of reported management net profits of $333m. Continued impacts from currency and low interest rates as well as increased costs from investment in product development are all expected to be headwinds for the business.

5. Intueri Education Group (ASX: IQE)

Announced the purchase of New Zealand Institute of Sport (NZIS) for NZD19.3 million representing a multiple of 5.5x the group's expected EBITDA of $3.5 million. NZIS's operations span 20 years focusing on providing certificate and diploma levels courses for some 1,000 students in courses involving sport, fitness and recreational sectors. Post this acquisition, **Intueri Education** will operate across 11 Colleges, involving some 13,000 students.

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Institutional Imperative

Introduction

Few would dispute the idea that the business world moves at a much faster pace these days. Rising regulatory demands alongside tougher compliance requirements is forcing the hand of many management teams. This is compounded by the normal pressures to meet and or exceed investor expectations. Those who are prepared to buck the trend by giving a business the time and freedom to blossom are a rare breed. The notion that time is your friend, is not one that sits comfortably with many in the investment world. The Economist noted in an article published during August 2015 that *"the average holding period for shares in America and Britain has dropped from six years in 1950 to less than six months today."*

As we outline below, the blow torch of competitive pressures are steadily intensifying across many industries and with that comes the added risk that many management teams will end up making bad business decisions in their haste to deliver. It is therefore vitally important that investors choose their leaders carefully, those that are not only well equipped to handle the changing market landscape but also pragmatic enough to resist the institutional imperative to conform. In doing so, they need to handle the pressures that the media, investment bankers and of course a company's own shareholders increasingly exert.

Media

It is said that journalists often write the headline before the story. Today, such is the power of online media that breaking news can have an immediate impact. At its core, reporting is meant to keep readers abreast of the latest development, be it weather, sports or breaking news. Reporting should be informative, accurate, responsible and objective. Unfortunately, the old adage of not letting the facts get in the way of a good story is alive in journalism and a modern society that demands instant gratification.

The problem which arises is that in exposing important issues, not all the facts are presented equally, leading to half-truths and omissions. This type of reporting applies pressure not only to those that have done wrong but also inadvertently shines the light on innocent parties. Here the unintended consequences are plain, forcing parties that have done little wrong to justify their position. The pressures applied can also lead to other consequences, which for investors can be far more financially damaging over the long run. Often in the pursuit of growth, financial ill-discipline is a constant companion.

Companies

Sitting on the other side of the online news world are the companies, often unaware of the pressure about to be applied. A perfect illustration is that of retailer Woolworths. Following its expensive foray into the hardware business via the Masters joint venture, the media and investment community has zeroed in on management, questioning its ongoing commitment to a venture that many now regard as an ill-conceived white elephant. When such stories break there is little a company can do. In the case of Woolworths few would argue that the Masters investment has been anything but a dud, however, it is important to distinguish between short term disappointment and abject long term failure. We certainly want management teams to make hard decisions when things don't go according to plan but equally we are concerned when the decision is made simply to appease the crowd.

From our vantage point we consider the way a company and its people address these pressures as a key qualitative indicator underpinning our reasons for investing. To succumb to share market pressure is a recipe for disaster and has given rise to "the institutional imperative".

An investor won't necessarily see the impact of this behaviour in the short term but over the long haul, it matters a great deal when consideration is given to its impact on real earnings per share growth. Warren Buffett provided an explanation of what "the institutional imperative" means in his 1989 Berkshire Hathaway shareholder letter when reflecting on his "Mistakes of the First Twenty-five years".

"My most surprising discovery: the overwhelming importance in business of an unseen force that we might call 'the institutional imperative'. In business school, I was given no hint of the imperative's existence and I did not intuitively understand it when I entered the business world. I thought then that decent, intelligent, and experienced managers would automatically make rational business decisions. But I learned over time that isn't so. Instead, rationality frequently wilts when the institutional imperative comes into play.

For example: (1) As if governed by Newton's First Law of Motion, an institution will resist any change in its current direction; (2) Just as work expands to fill available time, corporate projects or acquisitions will materialize to soak up available funds; (3) Any business craving of the leader, however foolish, will be quickly supported by detailed rate-of-return and strategic studies prepared by his troops; and (4) The behaviour of peer companies, whether they are expanding, acquiring, setting executive compensation or whatever, will be mindlessly imitated.

Institutional dynamics, not venality or stupidity, set businesses on these courses, which are too often misguided. After making some expensive mistakes because I ignored the power of the imperative, I have tried to organize and manage Berkshire in ways that minimize its influence. Furthermore, Charlie and I have attempted to concentrate our investments in companies that appear alert to the problem."

The problem, however, is that the company's rightful owners are invariably unaware of the financial damage about to be inflicted on the business. Most times the actions of management that venture down the "institutional imperative" pathway are only revealed over time. Unfortunately, by this stage the damage done is visible to all.

There are, however, boards and management teams that lead by example, creating a corporate culture that shuns the notion of growth for growth's sake, focusing more on what really counts over the long haul, driving real earnings per share growth.

Capital allocation

Capital allocation is arguably management's most important responsibility. This is what matters most but few appreciate its importance. As Warren Buffett noted, very few chief executives come prepared;

"The heads of many companies are not skilled in capital allocation. Their inadequacy is not surprising. Most bosses rise to the top because they have excelled in an area such as marketing, production, engineering, administration, or sometimes, institutional politics. Once they become CEO's, they now must make capital allocation decisions, a critical job that they may have never tackled and that is not easily mastered. To stretch the point, it's as if the final step for a highly talented musician was not to perform at Carnegie Hall, but instead, to be named Chairman of the Federal Reserve."

During the quarter a host of businesses updated investors on their capital allocation mistakes as set out in **Table 1**. This is not to suggest that management should avoid making investments but that greater upfront consideration should be given for the risk of getting it wrong. When write-offs invariably occur, as our table highlights, management often denotes their impact as being of a non-cash nature, thereby implying little damage to the shareholder. Technically, this is correct since the money invested is already long gone, leaving only the requirement to write down the asset value to a more appropriate level. More importantly though, investors have paid a big price, on earnings no longer available and a share capital base that is most likely significantly higher in number.

We outlined our thoughts on this subject in our review of the Seven West Media business in our June 2015 Quarterly Newsletter. In the 2015 results announcement the group confirmed the write down of $2,065 million of television goodwill and licences attached to its transaction with West Australian Newspapers. This was comprised of a $1,092 million write down in the first half, followed by a further $973 million reduction in the second half. Despite undertaking a rights issue just three months ago at $1.25 per share, management felt it prudent to revisit the existing goodwill sitting on the group's balance sheet. Unfortunately for shareholders the news wasn't good as the following comments from the Seven West Media accounts notes;

"This adjustment reflects revisions to our future growth forecasts, accounting for recent advertising conditions, prominence of new entrants and changes in future cost assumptions. The Directors consider it prudent to recognise this non-cash adjustment to carrying values of the assets in our business given the market dynamics that have become more evident in recent months."

We remain unenthused by the traditional media sector and operators like Seven Group have raised material cause for concern that shareholders will ultimately bare the full brunt of past capital allocation decisions gone wrong.

Table 1: Capital allocation gone wrong

Company	2015 Announcement	Impairment	Item
BHP Billiton	July	$US2,800m	Offshore US assets
Seven West Media	August	$2,122m	Goodwill
Arrium	August	$1,799m	Impairment
Orica	August	$1,650m	Goodwill
Origin	February & August	$705m	Oil & gas assets
AGL Energy	August	$578m	Impairment
Whitehaven Coal	August	$355m	Impairment
Worley Parsons	May & August	$325m	Goodwill & various
ALS	April	$290m	US oil & gas assets
Bradken	August	$259m	Goodwill & various
Computershare	February	$121m	UK acquisition
STW Communication	August	$79m	Impairment

Investor's role

Investors have an important role to play, balancing the need to remain sufficiently informed whilst resisting the temptation to act impulsively. It is not an easy position to be in, made more difficult by the knowledge that the original analysis underpinning the investment could be wrong. Irrespective of the investment outcome, there must be a preparedness to trust ones work and applaud management teams that show a willingness to avoid costly capital allocation decisions.

Backing business leaders who can chart a sensible course whilst ignoring external pressure is important in minimising the harsh reality that in business, things can and do go wrong. In truth, a business's achievement should be measured over a considerable period of time, acknowledging that plans often take longer to complete than originally anticipated.

The notion that a business can grow, year in year out, without missing a beat is hard to reconcile in the real world. Making things worse is the belief that buying growth will fill an earnings hole or allow a company to hit predetermined profit targets. It certainly might achieve all of the above and might even win the company short term supporters but that in itself won't lead to corporate success.

In our experience businesses rarely succeed by taking short cuts. On the contrary, success is very much about the long haul. Shunning short-term thinking requires a contrarian behaviour, one that is prepared to put at risk near term earnings to defend and improve a company's long term competitive position.

Over the years we have invested in a select number of businesses. Not all of our investments panned out the way we originally had hoped, but a large number have. The ones that have delivered the most are those that have been held for a considerable period of time. Many of these have disappointed on occasions but that in itself is a most telling point, that the direction was right even though the timing may have been a little off.

SFM

James Hardie (ASX: JHX)

We attended the James Hardie US investor tour held in Chicago during September. The presentations covered all of the group's operations but with a specific focus on the American operations. During 2015 the company reported record revenues of USD1.6 billion along with net operating profits of USD221 million.

History

The company's corporate history spans 127 years but the appointment of current CEO Louis Gries as manager of the group's first U.S. manufacturing-plant in 1991 and his subsequent rise to the top job in 2004 put in train a strong foundation that has delivered shareholders impressive, organically driven performance.

James Hardie was listed on the Australian stock exchange in 1951. In the years that followed, the company built up a diverse portfolio of building and industrial products businesses including a wide range of asbestos-based products.

In the mid 1980's the company pioneered its asbestos free fibre cement product. This would underpin the company's entry into the U.S. building materials market where its focus quickly shifted from roofing tiles to panel siding. This led to the establishment of the first manufacturing plant in 1991. Whilst history is littered with tales of Australian businesses that faltered in their pursuit of the U.S., the James Hardie fibre cement story is a rare exception.

35-90 Strategy

Integral to the company's success has been its almost single minded approach in building a fibre cement market share from a zero starting position. In 1996 CEO Louis Gries unveiled the group's key strategic goal, one focused on growing and capturing market share in the housing siding (cladding) market. The company describes this as its 35:90 strategy, with the long term aim of fibre cement products controlling 35% of the U.S. housing market for both external and internal use. Of fibre cement, the group's objective is to capture a 90% market share. Today, James Hardie is the world's leading supplier of fibre cement products, commanding the lion share of the U.S. market, where fibre cement enjoys an approximate 18% market position.

Intellectual Property

The group's ongoing success can be traced back to its considerable commitment to investment. As CEO Gries describes it, James Hardie is not like other building materials companies and purposefully avoids a me-too business strategy. Sitting at the heart of the company's philosophy is a constant development and ownership of intellectual property that gives rise to a differentiated suite of products.

Since 2000, the company has spent some USD395 million on research and development of the group's fibre cement products. This consistent and significant investment over the years underpins the competitive advantage the brand now enjoys.

An extensive manufacturing and distribution network has seen the company lift its market share whilst controlling its cost base. The economic moat that has allowed the business to flourish is driven by a management team that has stuck rigidly to a successful game plan that has involved;

1. A singular focus on the fibre cement market.
2. Separating asbestos issues from the group's core operations.
3. Products focused specifically on siding and trim.
4. Strong adherence to treating every cost as a variable expense.
5. Managing the business for acceptable investment returns even if product volumes drop.
6. Capturing market share, by focusing on new housing construction as well as the repair and remodel market.
7. A commitment to consistent investment in research and development.

The company's return on capital metrics that have consistently sat above 20% and hit 29% in 2015, are a testament to what management often refers to as its sustainable competitive advantage.

Management

Following the resignation of CEO Peter MacDonald in October 2004, the baton was passed to current CEO Louis Gries. With a strong operational background, Gries joined the group in 1991 as manager of the Fontana plant. In 2012, Gries took on the additional role of managing director of the U.S. business. His track record to date is reflective of his style, one that is focused on execution and strong in leadership. Our ability to spend some time with management during the investor tour confirmed that CEO Gries is without question a very candid, impressive manager. Currently aged 62, Gries has committed to stay with the company until 65, upon which time a new internal appointment will likely be made.

Operations

The business can be considered in two parts, the group's growth engine being the U.S. operations and the Asia Pacific region. For 2015, the US division contributed USD1.3 billion of sales and USD286 million or 75% of group operating profits.

Specifically focusing on the US division, the group operates nine manufacturing plants with an installed capacity of 3,260 million square feet of fibre cement and two research and development facilities that employs 2,279 staff with operating margins of circa 22%.

Core ingredients

The fibre cement product consists of some basic ingredients, pulp, cement, silica and water. The key is in the mix of quantities and the kiln treating time, a formula that the company keeps under very close wraps.

Growing market share

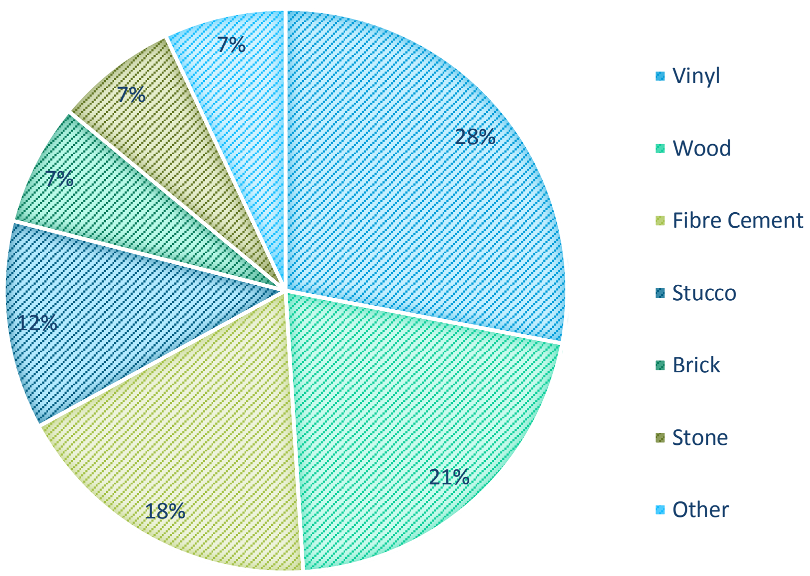
CEO Gries has consistently noted that in order to achieve its strategic objective of meeting its 35:90 target, the company needs to grow faster than the overall market. The company refers to growing ahead of the siding market's Primary Demand Growth (PDG), which is currently running at 4% pa. James Hardie targets annual PDG of 10%, so as to capture an additional

1.0% market share each year. It is in this context that investors can appreciate the time and effort required to fulfil management's intended goal of fibre cement capturing a 35% share from the current 18% share.

Strategy

The U.S. siding market has an estimated value of USD8 billion. Within this market, the main product segments and market shares are as follows;

Chart 1: Siding Market Share



If we were to venture back to 1991 when James Hardie first kicked off in the U.S., vinyl's position would have been closer to 50%, while the fibre cement industry was still in its infancy. Management have always maintained that vinyl's inferior product set would pave way for its growth. As such, the business model was predicated on taking market share from predominately vinyl and to a lesser extent the other competing materials.

This has involved a continuous process of improvement and customer engagement that targets product distributors, builders and contractors to exclusively market and sell the merits of Hardie's siding for both new housing construction and the repair and remodel market. The addition of colour and trim finishes has provided the company with the final pieces to allow for a complete building offering, thereby eliminating the need for competing products.

Photo: 100% Hardie - First Chicago home exterior built entirely with James Hardie product

Manufacturing Performance

Occasionally the Hardie's management team have stubbed their toe in managing the group's growth. Manufacturing production mishaps have caused some pain but the company has historically recovered to a higher level. Our tour of the research and development facility in Naperville Chicago, reinforced the company's attention to continuous manufacturing improvements. Too often, companies espouse what they intend to do only to fall short. In Hardie's case the numbers show the continuous progress made on extracting more from the same set of assets.

During the course of 2015 financial year, plant manager Sean Gadd noted that the company was able to produce more siding board without any increase in operating hours. In short, the group was able to capture a circa 10% efficiency gain, driving down unit costs and lifting operating margins above 25%. CEO Gries added that the company was now into its fourth manufacturing improvement cycle and that similar gains of 10% per annum could be expected for the next five plus years. The financial and competitive benefits that will flow from these initiatives should not be underestimated and reinforces management's core strength of focusing on what it can control rather than being weighed down by general market conditions.

Financials

Table 2 highlights the group's progress over the past five years. This progress should also be measured against annual US housing permits which have typically averaged 1.5 million starts over a period spanning 75 years. The fallout from the financial crisis in 2008 saw this number fall to just 500,000 and the rise since then has been slow and steady, hitting the 1.0 million mark during 2014.

This has caught out many industry forecasters who have been too been optimistic in their outlook. That said, there is general agreement based on leading indicators, including long term interest rates, housing affordability and even consumer confidence, with the trend for housing starts up and the average of 1.5 million likely to be reached over the ensuing years.

For James Hardie, the group looks to benefit from the general lift in demand as well as the shift from vinyl and wood to fibre cement. As the numbers reflect, overall group sales have risen from USD1.1 billion in 2010 to USD1.7 billion with US sales contributing the lions share. Operating earnings adjusted for items including asbestos payments, also rose hitting USD304 million compared to USD209 million in 2010. Earnings per share has improved from 31 cents to 50 cents while dividends have been reinstated from 2012 onwards.

Group operating margins have moved back above 20%, with all indicators pointing to further rises over the short to medium term. In terms of balance sheet, the group's ongoing commitment to asbestos payments coupled with an organically driven business model has resulted in a very conservative gearing structure. The company has maintained a largely net cash position over recent years, finishing 2015 with net debt of USD339 million, compared to operating earnings of USD304 million and a market capitalisation approaching USD8.0 billion.

Table 2: Financials 2010-2015

(USD)	2015	2014	2013	2012	2011	2010
Sales						
US	1,277	1,128	951	862	814	828
Asia	380	366	370	376	353	297
Total Net Sales	**1,657**	**1,494**	**1,321**	**1,238**	**1,167**	**1,125**
US	286	237	163	163	160	209
Asia	90	83	75	86	79	59
Group EBIT (adj)*	**304**	**253**	**181**	**195**	**184**	**209**
R&D expense	(26)	(24)	(26)	(21)	(20)	(19)
Other expenses	(46)	(43)	(30)	(33)	(36)	(40)
NPAT (adj)*	**221**	**197**	**141**	**144**	**117**	**133**
EBIT margin %	*22%*	*21%*	*17%*	*19%*	*20%*	*25%*
EPS (c) adj*	50	44	32	33	27	31
DPS (c)	88	45	43	4	-	-
Net Debt/(cash)	339	(126)	(159)	(409)	35	130
Share Price	17.32	13.64	8.81	7.47	5.50	5.89

Source: SFML Research, James Hardie

** Earnings adjusted for the impact of asbestos funding*

Asbestos Funding

In December 2004 the company signed a heads of agreement with the NSW Government to provide long term funding of asbestos related disease claims. Until then the funding that was available was insufficient to meet all sufferers.

Under the agreement, the company is committed to providing 35% of its annual free cash flows, which excludes dividends and capital expenditure, into the Asbestos Compensation Injuries Fund (ACIF) paid in arrears. Since its establishment the company has paid AUD721 million into the Fund and collectively, since 2001, a figure of AUD1.0 billion has been directed to asbestos disease related compensation.

While actuarial analysis indicates a remaining discounted payment estimate of AUD2.1 billion over future years, a peak payment may be reached in the next three years. This is obviously subject to what is currently known, although the U.S. experience which saw asbestos removed from the industry in 1970, some eight years earlier than Australia, provides some basis for comparison.

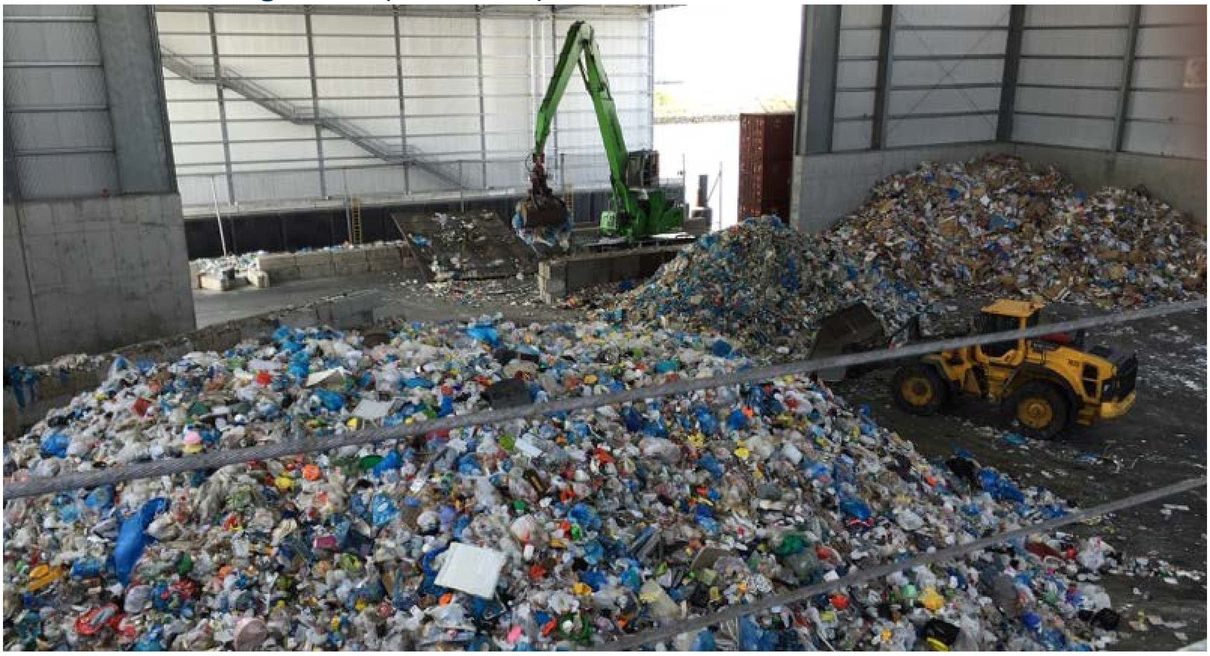
Final comment

When the asbestos issue raised its head in 2004, investors would have been forgiven if they had avoided this company for fear of the financial impact inflicted on both the business and its earnings performance. As we noted in our comments on asbestos funding, the company has not only paid out a substantial sum of money already but that further significant amounts are set to flow over the ensuing years.

It certainly has been a handbrake on shareholder returns and yet management have delivered both operationally and financially despite this. Even more impressive has been the focused commitment of a board and management team to stick rigidly to an organically driven business plan that embraces research and development in its pursuit of product differentiation.

Management have provided an adjusted net profit guidance range for the March 2016 financial year of USD240 million to USD270 million. This compares to USD221 million for 2015 and continues the positive trend established over recent years. James Hardie has rightly earned the respect of the investment community and all the indicators suggest the business is set for a period of prolonged success. ***SFM***

Sims Metal Management (ASX: SGM)



In general we seek investments that have;

1. High quality, enthusiastic management who have a clear plan,
2. A core business which can be a leader in its space,
3. Balance sheet strength through low levels of debt or even net cash. This provides management with both optionality and flexibility,
4. The potential for sustainable capital management that rewards equity holders with dividend growth over time.

While Sims Metal Management (SGM) may seem like an unlikely candidate, it does meet this criteria. We were initially drawn to SGM by a common sense change to the business model that resonated with us. History shows SGM was a clear leader in the Australian market before embarking on a series of rapid acquisitions including the transformational merger with Hugo Neu Corporation in the USA.

When Galdino Claro, a former steel mill Chief of Italian and Brazilian heritage, took the reins as CEO in 2013 he asked the following question – “Can we pull supply rather than push supply?”

The push strategy was about volume. Here you acquire as much scrap as possible and push it through the pipes and take the margin you get at the end. The pull strategy differs in that it requires a contract or arrangement to sell at a price. Scrap is bought to achieve a desired margin and pulled through the system to achieve the profit. Analysis is undertaken. Suppliers are measured and ranked. Unprofitable tonnes are not bought, less shredding occurs and better recoveries are sought. This made sense to us because it’s about internal levers that management can control.

Table 3: Sims Metal Management Financials and Targets

	Jun-13 Actual	Jun-14 Actual	Jun-15 Actual	Jun-18 Management Target
Underlying Earnings				
EBITDA $m	191.4	242.0	262.5	-
EBIT $m	**67.9**	**119.0**	**141.7**	**321.0**
NPAT $m	17.1	69.0	101.5	-
Return on Capital %	*2.30%*	*4.60%*	*5.50%*	***11.00%***
Balance Sheet				
Cash	46.9	57.2	316.0	
Gross Debt	200.7	14.9	2.1	
Cash flows				
GOCF $m	310.2	228.9	328.5	
Free cash flow $m	153.1	150.8	218.8	

Source: SFML Research, Sims Metal Management

So in September we attended the company's USA Investor Strategy day in New York. We spent a day listening to presentations from the senior management team in the USA. We toured the New York City municipal waste facility at Queens, the Claremont scrap yard complete with "mega shredder" that handled 99% of the steel from the fallen twin towers and finally we travelled the route of the barge operators. But first up Group CEO Galdino Claro and Group CFO Fred Knechtel took to the floor to deliver the message around their 5 year strategic plan. Their plan is centred on three pillars that drive two financial outcomes. The three pillars are;

1. *Streamline* the business – by exiting or restructuring non-performing assets.
2. *Optimise* the business – by focusing on improving supplier relationships, logistics, and systems that drive operational excellence.
3. *Grow* the business – by lifting market share and leveraging any unique capabilities into adjacencies.

The 5 year plan drives the two key stakes in the ground;

1. A Financial Year 2018 EBIT target of $321m (from current EBIT $141.7m)
2. A Return on Capital[1] (ROC) of 11% based on a $1.8b capital base.

The *Streamline* and *Optimise* programs will drive 90% of the uplift to the FY 18 target and the balance will be generated from *Grow*.

Streamline

The process of streamlining was initially forecast to contribute $32m of the $250m EBIT uplift over the 5 year period. To date Streamline has resulted in a combination of businesses being sold off and closed. This is effectively bookending the reign of the previous management team

[1] Return on Capital = Underlying Net Profit After Tax/(Equity + Net Debt)

who presided over a period of rapid expansion via acquisitions that tended to chase volume ahead of prudent financial outcomes.

Photo: Sims Metal, Jersey City Claremont Terminal – home of the "Mega Shredder"

Streamlining is also driving cost out initiatives. The goal is to shift the overall cost line down while making fixed costs more variable through initiatives such as outsourcing or flexible work solutions. This enables the business to flex costs down under the lower volume and price conditions that are being experienced today.

The initiatives being undertaken in the troubled Central Region of North America are active examples of the streamlining process. This is the most challenging region for the business. In July 2015 SGM idled the Memphis shredder and two additional facilities were closed. These actions will help SGM move to a break even position in the region but are unlikely to be enough to drive future profits.

While the 2015 Financial Year was not profitable in the Central Region the 4th Quarter did see a substantially improved result. However, the contraction in this region consumed all the benefits generated from improvements in the East and West regions. Collectively these three regions make up the North American business which is expected to be a major contributor to the 2018 $321m EBIT target. So structural change in the Central Region is a priority.

The problem with the model in Central Region is that SGM do not control the supply of scrap. Controlling scrap supply is key to the SGM "Pull model" identified in the opening paragraphs.

In the Central Region, SGM is competing directly with its clients, the very steel mills that it supplies. When SGM enters the market to buy scrap it is bidding for a limited supply against the region's steel mills who require feed. SGM is then hoping to turn around and sell the scrap back to the same mills at a margin. The situation creates friction with clients and is not sustainable. It is clear a new business model is required in the region.

Not surprisingly SGM is currently investigating a combination of new business models for the Central Region. These include potential for;

1. A toll treatment model - where SGM moves to run the steel mills non-core assets on agreed terms.
2. A buy, process, and supply deal. Preference would be given to specific mills that provide a defined mark up for SGM.
3. A 50:50 Joint Venture with specific steel mills.
4. An asset swap arrangement with steel mills. Non-core assets owned by a steel mill that pull supply from a distance can be operated more efficiently by SGM. Here SGM would swap or vend in assets close to the mill for the mill to operate.

Optimise

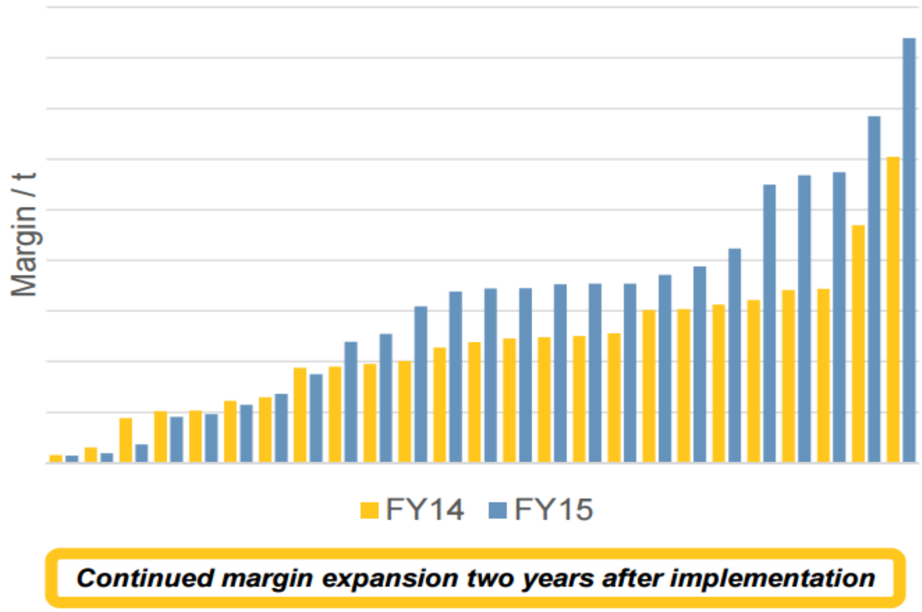
The optimisation is more complex and was designed to deliver the bulk of the EBIT uplift and restoration of the ROC to an acceptable 11%. At present there are over 400 separate optimise initiatives currently underway in the business. Optimisation is governed by a framework that has 4 key drivers.

1. Supplier Relationships
2. Logistics
3. Operational Excellence
4. Product Quality

Supplier relationships

If we were to focus on one take out message from the strategy day it would be the need to "control supply". For a Sims business to be successful it must control the supply of scrap.

Chart 2: Sims Metal Management Top 25 Suppliers – North American 'Test' Region



Source: Sims Metal Management

In regions where they do not control supply they can't control gross margins. As we have already discussed, the "Central Region" in the US is an example, where the company does not control supply. It follows that:

$$\frac{Group\ Revenue - Raw\ Materials}{Tonnes} = Gross\ Profit\ Margin\ Per\ Tonne$$

Controlling supply starts with Buying "right" from the "right" suppliers. It sounds simple but it has not been SGM practise until current management under Galdino Claro rolled out a test pilot in specific regions in North America 24 months ago.

The pilot leveraged off new software and back office tools used successfully in Australia and rolled out in the test regions. As a consequence all suppliers within the test regions were reviewed and ranked, thereby allowing SGM to measure the profits per tonne on an individual supplier basis.

Profitable tonnes are generated from quality scrap and scrap quality varies widely. Simply weighing a bunch of wrecked cars gives a poor measure of profit per tonne. Supply varies when cars are presented filled with dirt, with tyres still in place that are expensive to remove and destroy or when valuable copper wiring (Zorba – see operational excellence) is stripped out.

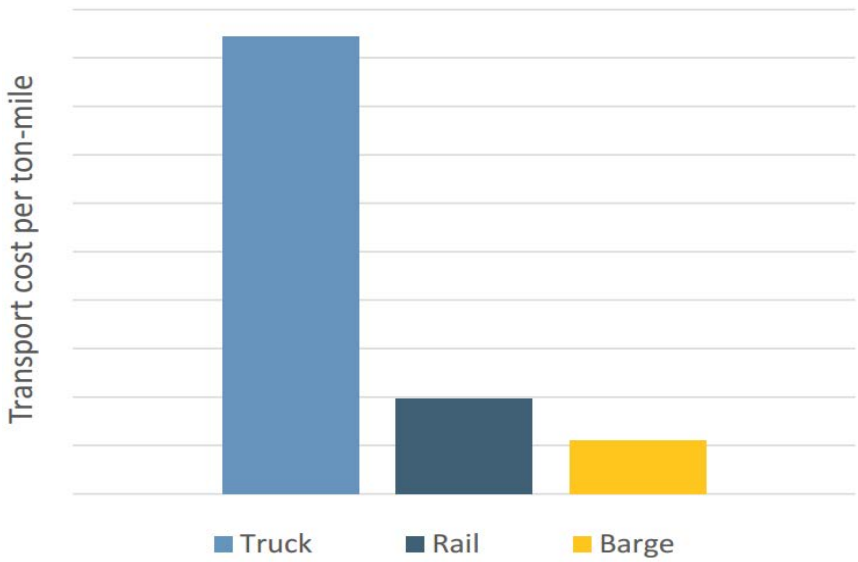
With improved analytics SGM can reward good suppliers with increased business. When suppliers are not supplying profitable tonnes, SGM won't buy from the supplier until they change their practices. As would be expected SGM now seek more tonnes from profitable suppliers, effectively rewarding good practise. Not surprisingly success here has been the biggest driver of gross margin improvement per tonne.

Fundamentally this is addressing the supplier base to see who is profitable, effectively giving SGM control over the supply of profitable tonnes, with the corresponding feedback loop reducing unprofitable tonnes. SGM claim that two years after the system was first introduced in the test regions gross margins continue to expand.

Logistics

SGM is increasing utilisation of low cost transport across its North American footprint. Barging tonnage by blue (coastal) or brown water (rivers) within the USA provides a significant cost advantage over tonnage that is road freighted. Maximising water based access is seen as a key competitive advantage by SGM.

Chart 3: Sims Metal Management US Transport Costs



Source: Sims Metal Management

Operational excellence

Optimisation involves changing the business mind set to lean thinking and making sure initiatives are executed daily and weekly to deliver desired outcomes.

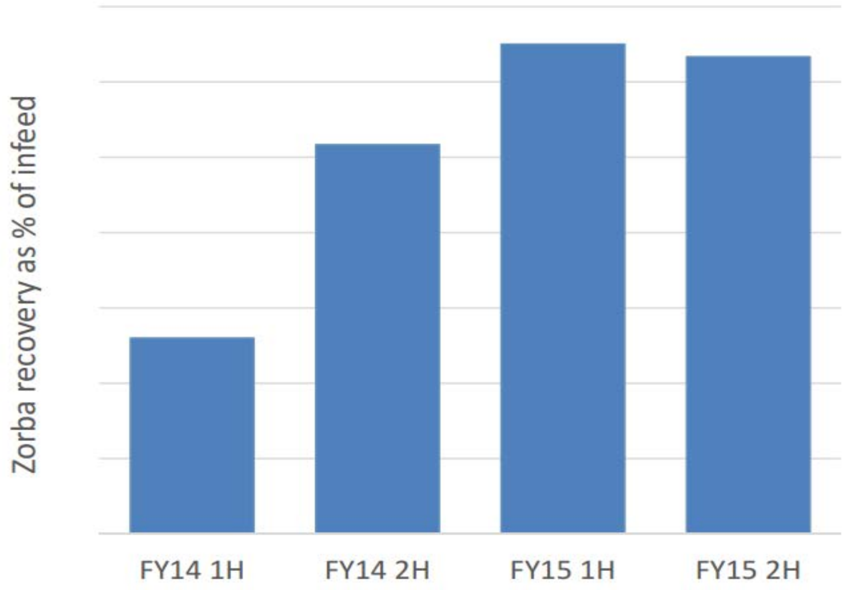
SGM has created a Project Management Office (PMO) that provides separate team leadership for each of the four drivers of Optimise. The PMO is coordinated by CFO Fred Knechtel ensuring a strong financial oversite of all 400 initiatives. Each initiative is identified, mapped, quantified, and the bottom line impact is risk accessed and weighted. We discuss the conservative risk adjustment of initiatives later in this note. The PMO has been operational for one year and has itself driven a high level of engagement across the SGM business.

At the strategy day presentation management presented Zorba recoveries as the poster child of operational excellence. Zorba is largely aluminium but also contains copper, brass and zinc components left after a wrecked car is shredded. It represents about 4% of the car by weight after it has passed through the entire downstream operation.

Photo: Shredded product 'Zorba', highly valued by the electronics industry

In general, zorba is the high value by-product of the shredded car that is in increasing demand due to the insatiable appetite from the electronics industry. On a per car basis this could equate to approximately 79Kg of metal.

Chart 4: Sims Metal Management's North America Metals 'Zorba' Recovery Rate



Source: Sims Metal Management

SGM claim that sharing best practice operating principals have driven a meaningful increase in metal shredding zorba recoveries. Metal loss monitors have been installed on all downstream plants with numerous small improvements compounding into large gains. Since the start of the 5 year plan, zorba recoveries have increased by 10%, which drives gross margin and lowers waste disposal costs. The appeal is that none of this is rocket science but rather common sense business management where internal levers can be pulled to drive margin expansion.

Product Quality & Services

It is clear to us that SGM are setting industry standards across a range of business measures including, safety, analytics, metal processing, e - recycling and market information.

In the past SGM's trading units had been separated by geography and material classification. Today they employ a simplified Global Trading structure that has resulted in improved communication flow and unified oversight. This information flow regarding markets and pricing is an important leg of the "Pull Model". It is the driver of the ongoing cycle that is approximately eight weeks long encompassing the writing of a contract, purchase of scrap to fill the contract and the logistics of getting to market efficiently, all with the aim of maintaining the margin per tonne no matter what the prevailing market conditions are.

This unit is headed by Bill Schmiedel an industry veteran who is also taking ownership of external projects such as developing the industry's first LME traded scrap metal spot contract.

Earning the right to Grow

The balance sheet is pristine with over $300M in net cash. At the strategy day and on the results call analysts peppered management with questions around the "lazy balance sheet".

We agree wholeheartedly with management that net cash means flexibility and optionality for the business.

It should also be understood that the business does require working capital as it grows. And this means cash. Working capital is released as inventory levels fall in a tight scrap supply market like today. As the US economy grows, confidence improves and consumers discard old white goods to replace them with new ones. The supply of scrap increases which is good. But this drives inventory levels funded through higher working capital. A short term approach to capital management will not work. It needs to be sustainable and any acquisitions need to be thought through.

Thankfully management have stated that they need to earn the right to grow. That means they need to deliver internal efficiencies in the business before they run off and acquire other, potential problems. Again we couldn't agree more. We understand that earning the right to grow means achieving a return on existing investments that is above the cost of capital.

The optimisation benefits achieved to date suggests that SGM may have initially been conservative on the early risk assessment work that was built into the 2018 profit target. We believe investors may continue to be surprised by efficiencies that are generated. At the strategy day, management noted that they had risk assessed each initiative conservatively. As an example, $1m of cost outs may be risked as high as 40%. Where this was the case, cost outs of $400K were built into the 2018 EBIT target, leaving significant upside if execution is reasonable.

In the third quarter of 2015 SGM experienced an 18% decline in intake volume combined with a 24% fall in scrap prices. The entire industry ground to a halt as those who held scrap refused to supply at spot prices. A partial earnings recovery in quarter four was assisted by SGM's raw material cost outs and supply chain based improvements of $47 per tonne.

As a result of these savings SGM is well placed to meet its 2018 targets due to the success of "optimise". On the full year earnings call in September 2015 management stated that "*If the volume levels of FY13 were matched in FY15, SGM would have achieved FY 2018 targets today*". To clarify, SGM would have delivered EBIT of $321m in FY2015. This is largely driven by the $47 per tonne improvement achieved to date. At the open day SGM stated *"a lot of additional benefit can still be gained from over 400 initiatives currently underway"*. Management are also confident they can deliver above cost of capital returns independent of external conditions. Clearly investors remain sceptical on both fronts at this point.

At the two year mark management are pointing to several factors that they believe demonstrate they are executing inline or ahead of the 5 year plan.

- The first is the uplift in EBIT. Underlying EBIT has doubled in the two years to date
- The second is that the ROC has been lifted to 5.5%, or around half the 2018 target of 11%.

For us the results generated to date demonstrate that the management team are making reasonable progress towards their targets. In summary they have:

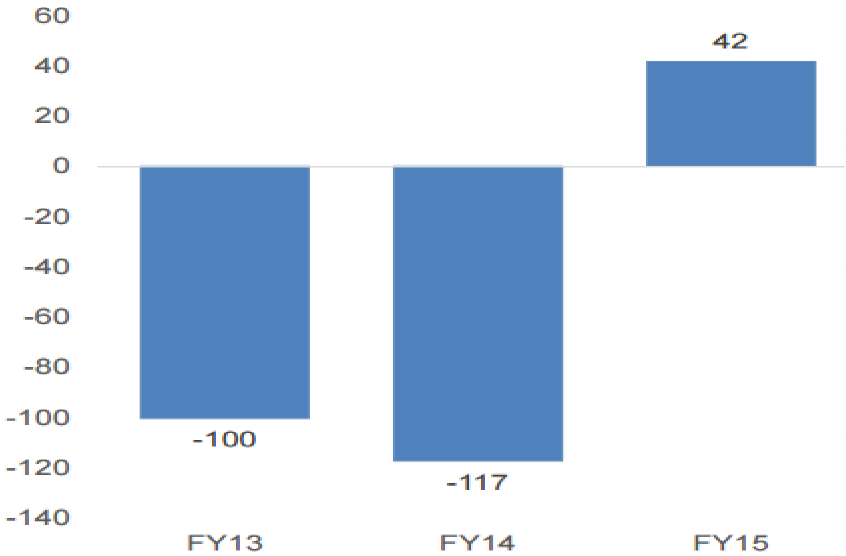
- Delivered a solid turn around in Europe and in particular e-recycling
- They have not concluded the streamline or optimise process
- Returns are not above the cost of capital yet
- However cash generation is strong
- They will grow by expanding what they do – expansion of municipal waste stream and e-recycling
- Potential for organic growth in parallel with the optimise phase
- Made wrong investments in the past because they had the cash
- Stated they need to earn the right to grow by charting a consistent path to achieve a minimum return on capital of 11%

Grow

Management had initially factored in a 10% EBIT uplift from the grow initiative of the 5 year plan. With cash building on the balance sheet significant optionality exists.

Grow will be organic and acquisitions driven. Share gains can come from exploiting competitive advantage as well as core market acquisitions.

Chart 5: Sims Metal Management Global E-Recycling Statutory EBIT



Source: Sims Metal Management

SGM has driven an impressive turnaround in Global E-Recycling. Today it has broad global reach across 33 facilities. After write-offs and impairments of over $200M during the 2013 and 2014 the group recorded a solid $42M EBIT contribution.

And according to Gartner research SGM is now the global leader in E-Recycling. On the back of this SGM is looking to identify new markets to deploy its expertise in electronics recycling. As the consumption of electronics changes so to do waste streams. An example is the ever increasing use of electronics in cars. SGM has plans to leverage its business knowledge to continue to be at the fore front in this changing space. These plans include;

- Electronic Commodity Recycling – municipal waste streams
- Asset Management Services – retire, recondition, reuse and destroy corporate assets
- Engineering and Consulting Services – corporate focused global solutions based on extensive footprint

Grow will also look at adjacencies such as the reuse of waste streams that are not currently monetised and developing new partnerships where value can be created. As an example, the 20 year Municipal waste stream model in partnership with New York City will be expanded and potentially recreated in other neighbouring markets.

Summary

Management

We left New York with a better feel for the US management team. There is no doubt they are engaged. Common sense seems to be a driving force and financial outcomes are at the fore front of decision making. In the Metals business, for example, a more scientific approach is being used to maximise margins. Some of the common sense elements include;

- The Pull system
- Minimised inventory exposure
- Better utilisation of equipment

Approximately 70% of export tonnes are now pulled. When prices fell in Q3 FY15, and all inventory was "pull based" no right downs occurred. This business is a constant battle on inventory transparency and management seem to have a much better handle on it.

Business

SGM is a global leader in e recycling and we see this as a strong component of its future direction and growth potential. The Australian business also possess leadership qualities. The US business is in transition and the Central Region is the key to this. The US footprint combined with superior logistics, information flow and scale will allow this business to become a strong leader in metals, municipal waste streams and E-Recycling in time.

Balance Sheet

For now the balance sheet is net cash. This provides the optionality and flexibility we seek in a business. A sensible approach to the "Grow" strategy should prevail. Acquisitions have been troublesome under prior management and current management seem to get this.

Capital Management

Sustainable capital management is achievable in the long term. Galdino Claro remains confident of the FY18 EBIT target and the stated cost of capital returns. Significant streamline and optimisation earnings improvements are still to come and growth is to be framed and executed.

SFM

Reporting season observations - the case for investment

The tougher economic environment is necessitating a broader business rethink. Restructuring, downsizing, call it what you will, the upshot is that management teams are renewing their efforts to protect existing market share whilst driving new revenue streams.

Not all are prepared to sacrifice short term profits and risk running foul of the "institutional imperative". But the competitive threats are real, suggesting those that fail to make the necessary investments today expose themselves to threats down the track.

There are those, however, that have the balance right. In some cases they are the incumbents and therefore, need to invest in order to stay ahead. Others simply appreciate the competitive strength that reinvestment offers a business. We leave such decisions to the executives in charge but note that our preference favours those with the vision and strategic nous to appreciate the importance of investing for tomorrow.

With the exception of Telstra and SAI Global, Selector is invested in all of the following businesses.

1. Telstra

Andrew Penn, Telstra's newly installed CEO, explained that a high investment profile was necessary to stay ahead of competitors leading some to downgrade the company's immediate earnings outlook;

"We have the best mobiles business in Australia, we have mobile leadership and we're absolutely determined to continue to invest to maintain our mobile leadership. We've announced we're going to increase our capital investment in the network and we're prepared to increase it again to do what we need to do to continue ensuring we have mobile leadership. If that impacts average revenue per user, if that impacts profit margins, well that's what will happen. But we're confident that's the right strategy for the long term."

2. Echo Entertainment

It wasn't that long ago that Echo Entertainment, owner of The Star casino in Sydney, was struggling in a multitude of areas. A $900 million capital expenditure program initially failed to deliver the goods, while the loss of local exclusivity following competitor Crown Resorts successful awarding of a restricted gaming licence in 2014 took its toll on management. The appointment of Matt Bekier as the group's new CEO following the departure of previous management was an important turning point.

As the former CFO, Bekier was well aware of the group's potential and embarked on a single but effective strategy. A back to basics approach saw the group sell its Townsville casino operation, concentrating all efforts on its Sydney and Gold Coast operations. As incumbent operator of the Brisbane casino, management also successfully won the right to develop the new Queensland Wharf Resort project, with an expected completion date of 2022.

The group's 2015 results, delivered in August, highlighted the positive business trends now underway with gross revenues rising 19% to $2.3 billion while operating profits jumped 20%

to $291 million. The importance of maintaining customer relevance reinforced the need for ongoing investment across the group's property operations, a point CEO Bekier noted;

"I think tourism is going to be a massive growth opportunity for this country for the next 20 years and as tourism builds up we want to be there to serve them through our integrated resorts. Once they are competitive, we have a physical offer that is attractive. If you then overlay the work that we're *putting into loyalty and customer service and branding and our partnerships, that will then set us apart."*

3. CSL
Another strong result, accompanied by news that the group was planning to undertake some significant capital investment in the lead up to new product releases expected in the near term. It is hard to argue with a management team that has executed the business case as well as CSL since first listing in 1994, however, the preparedness of management to outlay more capital still left some questioning the near term outlook, a view easily dealt with by CEO Paul Perreault;

"If you are going to spend the money it should be spent on things that are going to enhance shareholder value and grow the company. I don't mind spending some more profit, it's about 2% of what you would've expected to see in the outlook. It's all about reinvestment in the business as opposed to saying were just losing profit. We still have the profit, we're just reinvesting it in the business."

4. GBST
We profiled this provider of global software services for the financial markets in our September 2014 Quarterly Newsletter. Led by CEO Stephen Lake, the business has built up its services credentials in the key markets of Australia and the UK, where the group enjoys strong brand acceptance and a market leading position. Management is focused on broadening its coverage in both the Asian region and the US, where existing foundation clients are already in place. For 2015, the company delivered strong revenue growth and ongoing client success, with sales up 16% to $114 million along with cash profits rising 35% to $19.2 million. Management's conservative approach is reflected in a policy that expenses all research and development investment, a figure which totalled $11.7 million during the year.

Furthermore, the opportunity now open to the company has management committing additional funding over the next two years to enhance its product offering as well as capturing more client wins. This will come at some cost, with management pointing to an extra investment spend of circa $3 million. In turn, this is likely to keep a lid on profits for the current year, an outcome that some in the market clearly disliked. Post the group's results announcement, GBST's share price fell close to 15% as analysts lowered their earnings projections as a consequence of the additional capital outlay. We see merit in the investment and applaud management for putting the group's long term business health at the forefront of its decision making process. This may not win the company many additional investor friends but the underlying business performance thus far goes some way in justifying the group’s stance.

5. SEEK

We profiled the SEEK business in our June 2015 Quarterly Newsletter with a specific focus on the group's Chinese operations of Zhaopin. Following on from the company's trading update delivered late in the 2015 financial year, the company's year-end numbers were largely as expected with revenues up 20% to $858 million, while underlying net profits lifted by a more modest 6% to $190 million. Dividends were also raised 20% to 36 cents per share, continuing its conservative payout ratio.

Despite specific issues relating to the group's learning business, management continues to set a sensible and coherent strategy. Having benefited from being a "disrupter", CEO Andrew Bassat knows the importance of innovation, noting, "*In a rapidly evolving world, companies that do not re-invest face being disrupted or will miss large growth opportunities.*"

With this as a backdrop, SEEK also announced that it would step up its early stage investment pipeline in each of the group's core business areas of education, employment and international to take advantage of the global opportunities open to them. This will keep a lid on profits in the short term, evidenced by the 2016 revenue guidance of 15%-18%, while underlying net profits are expected to sit around the AUD200 million mark, excluding early stage losses.

In defining the group's strategic thinking that underpins the necessity to invest upfront, CEO Bassat noted that management always starts with the general premise of whether value can be added to any endeavour pursued. Timing is of lesser importance, citing some undertakings like SEEK Learning and Swinburne having delivered instant profits, whereas Zhaopin in China taking upwards of five years to break even. Interestingly, for 2015 Zhaopin recorded revenues and net profits of USD208 million and USD41 million respectively.

SEEK's preparedness to invest is not to everyone's liking particularly if it comes at the expense of profits in the short term. The institutional imperative would call for more today but that is contrary to how management view the world. In response to an investor question regarding the subject of short term earnings impact Bassat commented;

"If we believe something is going to deliver long term returns to our shareholders the timing of the payback is not as important as the impact. And to be frank this is where we differ from most other organisations. We are happy to take a ten year view rather than a twelve month view."

6. SAI Global

The 2015 year was an eventful one for standards group SAI Global. The loss of its recently recruited CEO was followed by the appointment of internal candidate Peter Mullins. Prior to Mullins's appointment the company was the subject of Private Equity interest, with a takeout valuation north of $1.0 billion. This would ultimately fail, with the company picking up the $5 million tab for the significant defence costs. A regrouped and refocused SAI has since embarked on streamlining the organisation’s multiple operating divisions.

We initially saw merit in management's undertakings and the results delivered in August provided evidence that better performances were now in train. Our decision to exit our holding was driven by our concerns that management had failed to learn from previous acquisition miss-steps. Organic growth is certainly our preferred option but we readily acknowledge that sensible acquisitions should not to be ignored or avoided.

However, track record also counts and on this score SAI has had mixed success. The company's appointment of a mergers and acquisitions executive, announced at the 2015 results briefing, was in our opinion a most telling and concerning development. Management has clearly signalled its desire to make significant acquisitions, having only just completed its own internal restructure.

Initially, we were prepared to give the management team the benefit of the doubt, thinking that a more focused and leaner organisation would finally deliver on its potential. Following these developments, we reverted to watching from the sidelines.

7. IRESS

For financial and wealth management services group IRESS, its strength is its earnings consistency and despite the market's negative response to its 2015 interim results, our take is group performance is solid, with new business activity at record highs. The relevance of this last point is indeed important as it is a leading indicator of future revenue streams. We most recently profiled the company in our September 2013 Quarterly Newsletter, where we wrote;

"in our experience value can be created by a management team that is prepared to build from scratch, with a long term game plan at hand. Building something from the ground up takes time, persistence and a preparedness to invest ahead of the curve. It is not an easy route and many management teams avoid this slower path preferring to undertake transformational deals."

Unlike SAI Global, IRESS has shown a deft hand with acquisitions, having undertaken a series over its long history. Importantly, the group's narrow business focus is complimented with a management team that considers the long term importance of any acquisition. It doesn't rely on appointed executives to uncover new opportunities, which just encourages activity for activity’s sake.

The market's most recent disappointment with IRESS stems from the fact that profit growth will be muted in FY2015 following its stronger performance in FY2014. This, simplistic assessment of the business obscures, however, the essence of what makes IRESS such an attractive investment. When taking on new customers, the company undertakes implementation work upfront, incurring the costs before realising the benefits of the subscription based revenue that follows. This annuity type revenue is both sticky and long in duration, so while upfront investment is required, the end prize is more than justified. Illustrative of this point, group revenues for the 2015 interim came in at $173 million, while underlying operating profits before tax were $52.6 million, continuing a long term earnings record.

8. Infomedia

As the Chairwoman Fran Hernon rightly noted, no one likes negative surprises but that's what shareholders of electronic parts catalogue group Infomedia received with the news that long term executive and current CEO Andrew Pattinson was stepping down from the top job effective immediately. As Hernon was at pains to explain, there was no crisis and that the company's business outlook remained very positive. The decision to seek a new leader was unanimous among the board and driven by a desire to have a fresh set of eyes on a business that has promised so much but has been prone to disappoint.

This was again reflected in 2015, with revenues and profits coming in short of management's earlier guidance. Yet despite these short comings, the business model remains incredibly attractive, employing low levels of capital whilst generating recurring monthly subscription income. We profiled the business in our March 2014 Quarterly Newsletter, outlining its business history since it first listed in 2000. In many ways the company is only now getting started. The pipeline for its services are strong, implementation pilots are underway, illustrated by the rollout currently in progress with Hyundai in the US, with more manufacturers expected to sign up.

Hernon has also ruled out providing future earnings guidance, having painfully learnt the errors of trying to forecast the likely timing of contract wins. Whilst management has little control over this, Hernon remains nevertheless confident in the group's ability to sign up new customers. At the close of 2015, the group held net cash of $16 million.

9. Sims Metal Management

The world's largest metal recycler is on the mend. Under the leadership of Brazilian born Galdino Claro, the group's lost years which included big acquisitions and equally big losses are now confined to history. As a scrap merchant, the Sims business model is significantly exposed to three variables, the volumes of scrap bought, the price paid and the eventual price received. Influencing the outcome of all three involves the daily moves in export prices and the availability of local scrap supply.

Of the three regions in which Sims operates, the most profitable remains the Australian and New Zealand Metals division. Here the group enjoys large market share positions. Europe Metals is next on the profit list while US Metals is a marginal operator despite its leading market share. It is quite revealing that a business like Sims, with 200 facilities, operating in 20 countries and employing over 5,400 employees struggles to earn a half decent return on capital.

In 2015 the group sold 10.5 million tonnes of scrap down from a recent peak of 14.5 million in 2012. This gave rise to USD6.3 billion of revenue of which the company booked an operating profit of USD95.6 million. As disappointing as these numbers are management is making steady progress.

Following his appointment as CEO in October 2013, Claro presented to the market his five year strategic plan. The results now being delivered are a direct outcome of Sims renewed business focus. Critically no longer will the company simply accept the market's volatility as justification for its lack of profits. To this end Claro has set an ambitious target of lifting the group's operating profits from the 2013 level of USD67 million to USD321 million by 2018. Should Sims achieve this target it would be earning a return on capital in excess of 11%, a vast important on the sub 5% it has struggled to achieve in the most recent years.

Long term strategic plans by their very nature are ambitious and prone to disappointment. Management has set a target that looks aggressive but Claro has consistently argued that not only does it remain realistic but its outcome will be based on a significant number of internal improvements rather than any reliance on external market forces. In all, over 400 strategic initiatives are underway throughout the company's global operations.

By June 2015, underlying operating profits had improved on its 2013 level of USD67 million to USD142 million, while the group's return on capital had doubled from a miserable 2.3% to a more encouraging 5.5%. The company's USD314 million net cash holding also positions the business incredibly well to execute on its plans. Management has a game plan and we remain positive in its ability to execute on this.

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Short Selling – The Long and the Short of It

It is common to see mention of "short sellers", "short covering" and "short squeezes" when the financial media tries to explain sharp movements in share prices. There is a range of opinions within the industry on the form in which short selling should exist, if at all. This article will attempt to shed some light on short selling in the equity market in Australia.

Below is a current list of the top five shorted stocks compiled from publicly available information on the Australian Securities and Investments Commission ("ASIC") website.

Table 4: Top Five Shorted Stocks as at 30 September 2015

Company	Total Product on Issue Reported as Short Positions
Metcash	22.06%
Slater & Gordon	16.72%
Cabcharge Australia	15.38%
Orica	14.96%
Myer Holdings	14.90%

Source: ASIC

What is short selling?

Short selling is a practice in which the short seller borrows a financial instrument from a lender and subsequently sells the securities in the open market. A range of financial instruments can be short sold including equities, bonds and commodities. In most cases the short seller is hoping to buy the securities back at a later date ("short covering"), at a lower price than they sold it for, in order to repay the loan and bank a profit.

When the short seller borrows the financial instrument prior to selling, this is known as **covered short selling**. You might also hear the term **naked short selling**, which is where the short seller has not borrowed the financial instrument prior to executing the sale, and is often viewed as problematic to the functioning of the equity markets. As part of the short selling measures taken by the regulators during the Global Financial Crisis ("GFC"), most naked short selling in the stock market was permanently banned. [2]

As a market participant, what is the motivation to short sell?

The general motive of a short seller is directly inverse to the traditional maxim "Buy Low, Sell High", whereby short sellers aim to "Sell High, Buy Low". There are two primary reasons why a market participant would want to conduct a short sale transaction. The first is **speculation,** a directional trade where the short seller attempts to profit from a fall in the price of the security. The second is **hedging**, where the short seller attempts to reduce the risk of adverse price movements in another related security. One such example of participants that use short selling as part of a hedging strategy are the derivative market makers that quote prices in Exchange Traded Options ("ETOs").

[2] ASIC RG 196 Short Selling, http://download.asic.gov.au/media/1241087/rg196-short-selling-20110429-updated-asx200-to-asx300.pdf, Accessed 21 September 2015.

As a shareholder, why would I lend out the shares in my portfolio to a short seller?

Shareholders lend out stock to short sellers because they can generate additional income from the fees charged to the borrower.

The short seller will post collateral against the stock loan, in the form of either cash or securities, equal to the notional amount of the shares borrowed plus a small risk margin. If cash is used as collateral, the lender will invest it in money market securities such as treasury notes, earning a market determined risk free rate of return. The lender will pay the interest generated on the collateral to the short seller, but only after deducting a lending fee. In some cases if the stock is in short supply and hard to borrow, the lending fee can be very high and outstrip the interest earnt on the cash, in which case the borrower will have to pay the lender to cover the difference.

While it is called a loan, it is actually a transfer of ownership to the borrower with a promise to return equivalent shares to the lender at a future date. Even though title of the securities is transferred to the borrower in what would appear as a sale, under certain conditions securities lending does not trigger a capital gains tax liability. The conditions include that there is a written securities lending agreement and that the equivalent security is returned within 12 months.[3]

The short seller must pay the lender all entitlements including dividends and rights. The shareholder also maintains the right to recall the stock at any time, which may happen if they wish to exercise voting rights or sell their shares. In this case the short seller would need to arrange an alternative source for the loan, or buy the shares back at the market price. If there was a market wide event where a large proportion of stock was recalled, this could lead to a "short squeeze", where short sellers are forced to purchase the securities on market to repay the outstanding loans.

Stock lending can be a lucrative practice for asset managers and for index funds in particular, since they have a much lower turnover within the portfolio a larger portion is available to lend.[4]

What is the history of short selling?

The first reported case of short selling occurred in 1609. Dutch trader Isaac Le Maire, a large shareholder of the Vereenigde Oostindische Companied (VOC), decided to sell not only his shares in the company, but more shares than he owned. Stakeholders of the company called Le Maire's action "outrageous," and it eventually led to the first real stock exchange regulation: a ban on short selling. The ban was withdrawn a few years later.

Since then, short selling has been a part of financial markets to varying degrees. It received increased attention during the events of the GFC, and led to renewed academic interest and attention from the regulators worldwide.

[3] Securities Lending & Superannuation Funds (2008), AFSA Policy Paper.
[4] Passive Investing: The Role of Securities Lending (2015), Blocher, J & Whaley, R.

What regulations are in place in Australia?

Short selling in Australia is regulated by both ASIC through the Corporations Act 2001 (Section 1020B) and the Australian Securities Exchange ("ASX") through the ASX Market Rules (Section 19).

As financial turmoil gripped global markets during the height of the GFC, ASIC placed a temporary ban on short selling between September and November 2008. The ban on short selling financial stocks lasted until May 2009. In addition to the temporary bans, the ASX abolished naked short selling in September 2008.

In March 2009 the Australian Government released a consultation paper on the current short selling disclosure regime, seeking feedback on the content of the regulations from stakeholders including brokers, fund managers, shareholder groups and regulatory bodies.

The regulations aimed to increase the transparency of short selling and securities lending. Recommendations from this report included two new forms of reporting requirements mandated under Regulatory Guide 196 ("RG196").

The first is ***Short Sale Transaction Reporting***, where an Australian Financial Services ("AFS") licensee who makes a covered short sale must report the sale to the market operator by 9 am on the following trading day. The market operator aggregates this information and publishes it to the market.

The second is ***Short Position Reporting***, where short positions above a threshold must be reported to ASIC who then aggregate this information and publish it to the market.[5] These reports can be downloaded from the ASIC website.

Can you tell which market participants are short which stocks?

When investors purchase over 5% of the shares on issue in a company, they must lodge a substantial shareholding notice, as well as whenever their holding moves above or below this threshold, and with any change of 1% or more. This notice is released publicly to the market.

In Australia, there is no equivalent disclosure for short selling. The Commonwealth Government decided not to release the disaggregated data collected from investors, instead choosing to release the aggregated data only. This provides the market with an accurate indication of the overall level of short positions in the stock, but does not give any insight into which fund managers are shorting which companies. This decision was made in light of feedback received from the 2009 consultation paper, with the respondents expressing concern that disclosure may compromise the proprietary value of trading and hedging strategies, as well as making them potential targets of the media, listed companies, or other investors because of their trading activity. [6]

[5] Australian Securities and Investments Commission, http://asic.gov.au/regulatory-resources/markets/short-selling, Accessed: 15 September 2015

[6] Short Selling Disclosure Regime (2009), Regulation Impact Statement, Australian Government – The Treasury

Does short selling cause market volatility?

Intuitively one might think that short selling causes excess volatility in the market. However numerous studies have shown that this may not be the case. One particular study conducted by Helmes, Henker and Henker (2010) compared the impact of the short selling ban on financial stocks in Australia during the GFC against financial stocks in Canada which were not subject to a short selling ban. They concluded that imposing constraints on short-selling reduced trading activity, increased bid and ask spreads and increased intraday volatility. They also found no evidence for lasting price support from the restrictions.[7]

There is concern around predatory trading tactics which may be occurring. For example during the GFC, because they had banking covenants linked to their market capitalisation included in their loan documentation. This meant that sharp declines in the share price could lead to a breach of the loan conditions and prompt re-negotiations of debt provisions at the worst possible time as credit liquidity had all but dried up. This potentially invited speculators to push the price of their shares down to cause a breach of the conditions and materially impact the operating ability of the company, creating a positive feedback loop and windfall gains for speculators.

Is there a correlation between share price movements and short interest?

Below is a chart which plots the share price of Flight Centre against the aggregate reported short positions in the stock. It gives an interesting insight into the mechanics underlying moves in the share price.

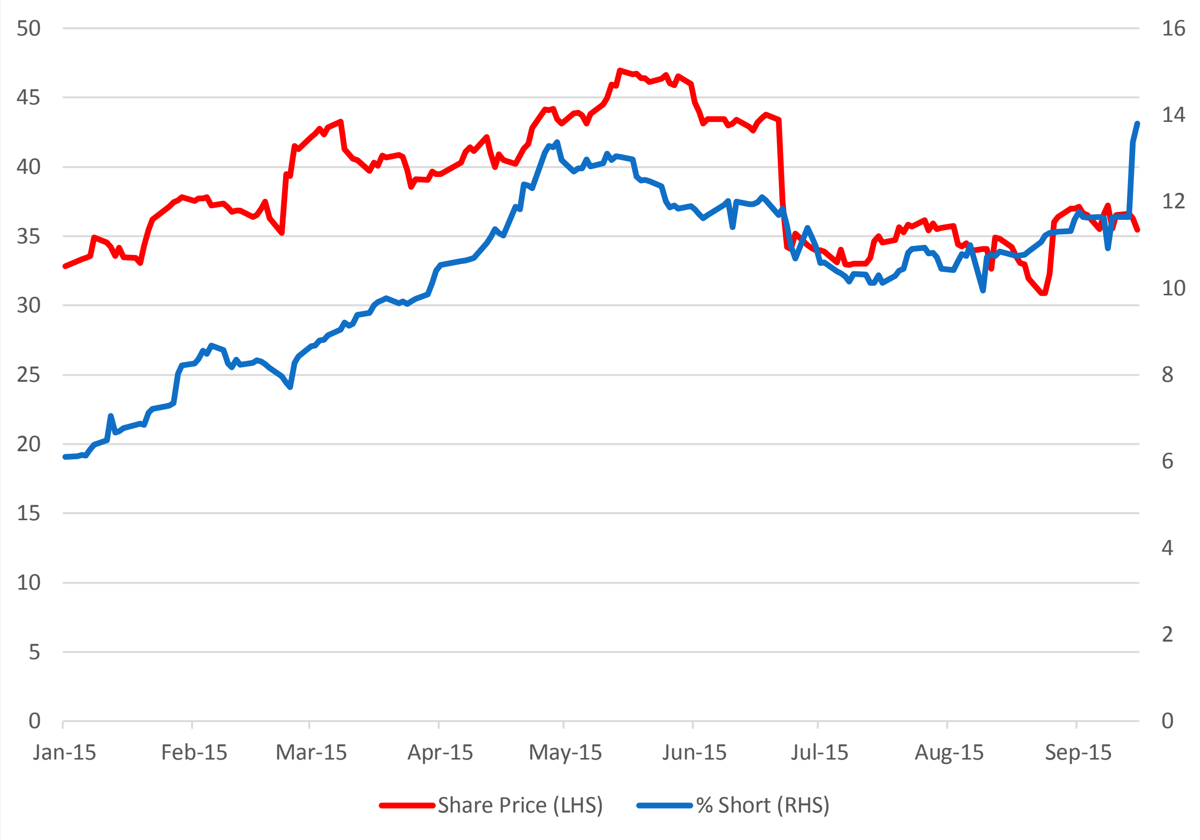
In June the share price closed sharply down 13.59% after the company issued a profit warning. The net short position on this day increased by 1.2%. The following day, the stock fell a further 8.8%, but the net short position actually decreased by 3.3%, indicating that there was excess buying on this day as short sellers were covering their shorts, thereby preventing a steeper decline in price.

When we analysed the data from the previous 179 trading days in Flight Centre, we found that in 89 days the share price and the short interest moved in the same direction, and in 90 days it moved in opposite directions. The correlation between the data came out very close to zero, indicating there was insufficient evidence to suggest a meaningful relationship between a change in the short interest and the share price. This is contrary to what many investors would expect at first glance.

It would be interesting to run further studies such as this, over longer time frames and a broader range of securities to ascertain if this finding still holds over larger data sets.

[7] The effect of the ban on short selling on market efficiency and volatility (2010), Helmes, U, Henker, J & Henker, T.

Chart 6: Flight Centre Short Interest vs Stock Price



Source: ASIC, IRESS

What is our view in summary?

Short selling is part and parcel of financial markets in Australia. While it is not favoured by some, there is evidence to suggest that it can indeed improve the efficiency of the markets. Since the GFC, the regulators have increased their oversight and enforced reporting requirements that provide greater transparency to the market.

More research into preventing predatory trading tactics might prove beneficial to the overall operation of the market, arming regulators with more information to refine the regulatory guidelines, and give investors comfort that they are not being subjugated by the less transparent and less understood segments of the investment community.

What is clear is that in the short term, share prices can be impacted by all matter of events extrinsic to underlying company performance; whether it be short selling, short squeezes, speculation, margin calls, or indiscriminate buying from index funds.

However as we lift our eyes further to the distant horizon, in the long term, all this price noise diminishes into a dull murmur. When we reach this plane, all that really matters is finding good businesses with leadership qualities, underpinned by strong balance sheet, run by competent management teams, with a prudent focus on capital management.

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Company visit diary September Quarter 2015

July

NIB	NIB Holdings conference call acquisition	08/07/15
SEK	SEEK trading update	08/07/15
ALU	Altium conference call	09/07/15
IPD	Impedimed management meeting	22/07/15
NVT	Navitas FY15 results briefing	27/07/15
RMD	ResMed FY15 results briefing	31/07/15
CAT	Catapult management meeting	28/07/15

August

IQE	Intueri Education Group conference call	05/08/15
OFX	OzForex Group FY15 results briefing	05/08/15
PXS	Pharmaxis management meeting	07/08/15
ANN	Ansell FY15 results briefing	10/08/15
AGI	Ainsworth Game Technology gaming expo	11/08/15
ALL	Aristocrat Leisure gaming expo	11/08/15
DMP	Domino's Pizza Enterprises FY15 results briefing	11/08/15
COH	Cochlear FY15 results briefing	11/08/15
GBT	GBST Holdings FY15 results briefing	12/08/15
EGP	Echo Entertainment FY15 results briefing	12/08/15
CPU	Computershare FY15 results briefing	12/08/15
CSL	CSL FY15 results briefing	12/08/15
REA	REA Group FY15 results briefing	12/08/15
SRX	Sirtex Medical FY15 results briefing	13/08/15
JHX	James Hardie Industries Q116 results briefing	14/08/15
ALU	Altium conference call acquisition	14/08/15
GBT	GBST Holdings FY15 management meeting	17/08/15
FXL	Flexigroup FY15 results briefing	17/08/15
CWN	Crown Resorts FY15 results briefing	17/08/15
SAI	SAI Global FY15 results briefing	18/08/15
MND	Monadelphous Group FY15 results briefing	18/08/15
JHX	James Hardie Industries investor relations meeting	18/08/15
AGI	Ainsworth Game Technology FY15 results briefing	19/08/15
SEK	SEEK FY15 results briefing	19/08/15
ZPIN	Zhaopin FY15 results briefing	19/08/15
IQE	Intueri Education Group HY15 results briefing	20/08/15
IRE	IRESS HY15 results briefing	20/08/15
SGM	Sims Metal Management FY15 results briefing	21/08/15
IFM	Infomedia FY15 conference call	21/08/15
MYS	MyState FY15 conference call	21/08/15
IPP	iProperty Group HY15 results briefing	21/08/15
NHF	NIB Holdings FY15 results briefing	24/08/15

BRG	Breville Group FY15 results briefing	24/08/15
VRT	Virtus Health FY15 results briefing	25/08/15
JIN	Jumbo Interactive FY15 results briefing	25/08/15
ALU	Altium FY15 results briefing	25/08/15
SDF	Steadfast Group FY15 results briefing	26/08/15
SGM	Sims Metal Management meeting	26/08/15
MYO	MYOB Group HY15 results briefing	27/08/15
FLT	Flight Centre FY15 results briefing	27/08/15
BKL	Blackmores FY15 results briefing	27/08/15
ACX	Aconex FY15 results briefing	28/08/15
IFL	IOOF FY15 results briefing	28/08/15
IPP	iProperty Group HY15 management meeting	28/08/15
MVF	Monash IVF Group FY15 results briefing	31/08/15

September

FLT	Flight Centre management meeting	01/09/15
IFL	IOOF management meeting	01/09/15
SRX	Sirtex Medical investor relation conference call	04/09/15
SGM	Sims Metal Management US investor tour	08/09/15
JHX	James Hardie US investor tour	10/09/15
IPH	IPH management investor briefing	15/09/15
NVT	Navitas conference call	17/09/15
FAN	Fantastic Furniture management meeting	18/09/15
ORL	Oroton Group management meeting	18/09/15
WBB	Auswide Bank management meeting	21/09/15
IFM	Infomedia meeting	23/09/15
JIN	Jumbo Interactive management meeting	23/09/15
PXS	Pharmaxis investor presentation	24/09/15
ACX	Aconex investor relations conference call	25/09/15
BAL	Bellamy's Australia management meeting	28/09/15
IPH	IPH management meeting	28/09/15
GBT	GBST Holdings management meeting	29/09/15