



In this quarterly edition we review performance and attribution. We focus on barriers to entry. We revisit solar & we make a comment on the National Broadband Network.

About Selector

We are a boutique fund manager and we have a combined experience of over 60 years. We believe in long term wealth creation and building lasting relationships with our investors.

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

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

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

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

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

Dear Investor,

The headline numbers would suggest that the last twelve months have been a rather benign affair, with the All Ordinaries Accumulation Index managing to sneak home with a 3.31% gain for the year. However scratch below the surface and the events of the past year would tell a more interesting story. Perhaps the key point to highlight is that, having endured a rocky start to the year, the market ended at its highest level, buoyed by a strong local economy and positive influences from the US markets.

Corporate activity has been a real feature as boards and management teams revisited growth levers, highlighted in an article that featured in our recent September quarterly newsletter. In particular, growing investor appetite for anything pulled out of the ground really cemented 2010 as a bull year for resources. Gold, iron ore and coal stocks could do no wrong as China and India stepped up to the plate.

It seems investors weren't the only ones who cottoned onto this, with the Australian Government looking to become joint partners with the resources sector. Having spent billions during the global crisis, it seemed only right that this new found wealth was shared around. Unfortunately, Government intervention is a growing worldwide trend. Banks couldn't escape the Government's clutches either, with new reform tabled late in the year.

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Offshore, the signals have been mixed. Europe is not one country but a collection of economies, linked in large part by a common currency, the Euro. That the markets have not capitulated, despite the debt carnage that has engulfed countries including Greece, Ireland, Portugal and Spain perhaps illustrates investor optimism of better times ahead. In the US, the Dow Jones Industrial Average also ended on a high, finishing up 11.03% to 11,578 points.

In this newsletter, we continue with a review of two portfolio stocks under our lead article titled "barriers to entry", focusing on why some businesses, when compared to others, deserve to trade on much higher valuations. We revisit an earlier review on the solar power industry and comment on the Government's National Broadband Network. Finally, for the December quarter 2010, we are pleased to report that the Fund's portfolio value rose 9.4% compared to a 5.3% rise in the index (refer portfolio statistics page 24). We extend our best wishes to all our investors and trust that you enjoy this latest quarterly report.

Regards
 Tony Scenna
 Victor Gomes
 Corey Vincent

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Performance December Quarter 2010

For the December quarter 2010, the Fund delivered a net gain of 9.37% outperforming the 5.31% rise in the All Ordinaries Accumulation Index. Performance statistics are detailed on page 24.

Performance table since inception – net returns after all fees

% Returns	Fund %	AOAI %	Difference %
3 months	9.37	5.31	+4.06
6 months	16.52	14.46	+2.06
1 year	0.33	3.31	-2.98
2 years	25.79	20.08	+5.71
Since inception compound pa	7.44	8.49	-1.05

Top 10 December 2010*	Top 10 September 2010*
Billabong International	Blackmores
Cochlear	Cochlear
Flight Centre	Flight Centre
IOOF Holdings	IOOF Holdings
IRESS Market Technology	IRESS Market Technology
Pharmaxis	Pharmaxis
ResMed Inc	ResMed Inc.
SIRTeX Medical	Seek
Whitehaven Coal	SIRTeX Medical
WorleyParsons	Whitehaven Coal
Top 10 = 67.2%	Top 10 = 67.9%

*Listed in alphabetical order

Selector runs a high conviction index unaware stock selection investment strategy with typically 15-25 stocks chosen for the Fund. As shown above, the Fund's top 10 positions usually represent the great majority of its equity exposure. Current and past portfolio composition has historically been very unlike that of your average run-of-the-mill "index hugger" fund manager. Our stock selection to this point has not included either retail banks or the large resource companies, RIO and BHP. Our goal remains to focus on truly differentiated broad cap stock selection rather than the closet index hugging portfolios offered by most large fund managers.

Performance attribution for the quarter

Top 5 stock contributors	%	Top 5 stock detractors	%
Pharmaxis	2.75	Seek	-0.63
SIRTeX Medical	1.96	Aristocrat Leisure	-0.48
Flight Centre	0.94	News Corporation	-0.04
IOOF	0.65	Billabong International	-0.02
Campbell Brothers	0.63	Reece Australia	-0.01

During the final quarter of 2010, the Fund reported an overall gain of 9.37% against a 5.31% rise in the index, with the majority of portfolio holdings contributing to this outcome. Topping the list of positive performers were the healthcare stocks, namely Pharmaxis, and SIRTeX Medical as well as Cochlear (profiled in this newsletter) coming in at number six, with a 0.59% contribution.

Pharmaxis in particular has endured a roller coaster year, largely on the back of regulatory delays to its key Cystic Fibrosis pharmaceutical drug Bronchitol. However things appear to be on the up with the group chalking up a number of significant recent milestones including, US health Food and Drug Administration (FDA) marketing approval for Aridol for the assessment of bronchial hyper-responsiveness in patients who are susceptible to having asthma, Australian Advisory Committee (who advise Australia's health agency the Therapeutics Goods Administration - TGA) recommending approval for the marketing of Bronchitol and the group's second Phase III results reporting excellent response in the open label component of the trial (beyond initial six month trial period). The focus will now shift to Europe, as the group seeks to gain European marketing approval for Bronchitol during the first quarter of 2011.

As to the Fund's detractors, profit downgrades from Seek, Aristocrat Leisure and Billabong International led to investor disappointment. Particularly concerning was the decline in local earnings for gaming manufacturer Aristocrat. While we are prepared to give management some leeway here, our concerns regarding the overall health of the industry saw us exit the business during the quarter.

As we step into 2011, the risk of further company profit downgrades across the share market landscape appears a high probability. Offsetting this, renewed US investor confidence and heightened corporate activity suggests the coming year will be an eventful one. *SFM*

Barriers to Entry

1. Cochlear (COH)

This quarter one of the very first stocks selected for the Fund back in 2004, at an average entry price of \$26.00, saw its share price hit an all time high of \$81.63. While it still remains a core holding in the portfolio, even more pleasing has been the company's growing global dominance over this period. If pushed to nominate a single reason why this is the case, we would gravitate towards the significant barriers to entry that new entrants need to jump.

In fact Harvard university professor Michael Porter nominated barriers to entry as one of "five forces" impacting the durability of a company's market position. The remaining four forces included: (1) the intensity of current market competition; (2) the threat of substitution by alternative products; (3) the strength of a company's customers; and (4) the strength of a company's suppliers.

Fortunately for investors, hearing implant manufacturer Cochlear hits all the right notes when it comes to Porter's "five forces". Many of these qualities have been highlighted in our previous newsletter editions, however recent events surrounding nearest competitor Advanced Bionics - now wholly owned by listed Swiss based Sonova Holdings, following its takeover in November 2009 for US\$489 million - have underscored the competitive moat that Cochlear has built over the past thirty-two years.

In the world of pharmaceuticals and medical devices, the fear of a drug or device being publically pulled from the market, due to safety concerns, is never too far away. Such events are brand damaging and life threatening, not only for the patient groups affected but the companies involved. Avoiding such events is not just a matter of good luck as some might suggest. More often than not, it actually comes down to unsustainable business models, with weaker technologies, becoming exposed.

In the case of Advanced Bionics, the company has real form when it comes to product recalls. Since receiving US Food and Drug Administration (FDA) approval in 1996, it has seen fit to recall its CLARION and HiRes 90k cochlear implants on five separate occasions since 2002, as set out in **Table 1**. The most recent event took effect on 23 November this year, with the worldwide voluntary recall of its HiRes 90k implants.

Despite these ongoing setbacks, the company successfully returned to the market on each of the previous occasions, having seemingly rectified the issue. Although the company has made no comment on a possible return date this time, brand damage must surely take its toll, evidenced by Cochlear's growing market share over the past decade.

Table 1: History of Advanced Bionics cochlear implant recall

Year	Product Issue
July 02	Advanced Bionics suspends CLARION systems after increased incidence of post cochlear implantation meningitis.
Mar 06	Global recall of HiRes 90k implant due to moisture leakage.
Apr 06	Recall of HiRes 90k Auria processor due to recurring static-noise interference.
Nov 09	Recall of select number of implants due to faulty weld.
Nov 10	Worldwide recall of HiRes 90k following "...at least two recipients experienced severe pain, overly loud sounds and/or shocking sensations, at 8-10 days after initial activation."

The third force in cochlear implants, European based Med-El has also run afoul of regulators, when in December 2004 US FDA authorities banned the importation of their implants due to concerns over manufacturing practices. Having only secured product approval in 2001, Med-El's reputation in the US market suffered as result, a situation that has yet to see the group regain its credentials.

In stark contrast, the oldest player in the cochlear implant space, Cochlear, has avoided such disasters, maintaining a 28-year unblemished manufacturing track record. Since its first commercially available multi-channel implant in 1982, the company has remained the global leader in cochlear implants. Underpinned by the pioneering efforts of Professor Graeme Clark, who in 1967 began researching the possibilities of an electronic implantable hearing device, continuous product generation has become a hallmark of the group.

In many ways, Professor Clark's life-long commitment to find a solution to restore hearing and described as a 'long journey into the unknown', speaks directly to the failures that are needed in order for success to ultimately flourish. A recent Australian Financial Review article on 7 December 2010 titled "Failure is the path to success" noted:

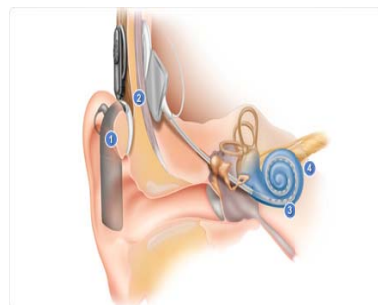
“Apparently a high failure rate is a hallmark of creative geniuses. Thomas Edison for example is said to have patented 1,093 inventions throughout his lifetime, including the long-lasting light bulb, phonograph and motion picture camera. Edison conducted 700 experiments trying to invent the electric bulb and was asked by a reporter from the New York Times what it felt like to have failed 700 times. I have not failed once. I have succeeded in proving that those 700 ways will not work. When I have eliminated all the ways that will not, I will find the way that will work. Edison also famously said, “I failed my way to success.”

As **Table 2** sets out, Cochlear has continued to build on its initial success with the new Cochlear Nucleus 5, the group’s latest unit, reflecting the 5th generation implant that is 40% thinner and two and half times stronger than the current implant.

Table 2: Cochlear Implant Product Evolution

Year	Product Release
1982	First multi-channel implant system.
1986	First Nucleus 22 cochlear implant.
2002	Nucleus 24 Contour Advance implant.
2005	Nucleus Freedom.
2009	Nucleus 5.

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When the company launched the next generation Nucleus 5 implant in late 2009, it sent a clear message to competitors, that it was setting new benchmarks in cochlear implant technology. CEO Chris Roberts, who joined the business in 2004 called it a “game changer” and has been instrumental in taking the business to new heights. He clearly understands the technology and the market opportunity that awaits the company;

“What continues to impress me are the fundamentals of the business, and by that I mean how well the technology works, its cost effectiveness, the size of the market, its potential and our competitive position.”

And as competitors stumble, doing untold damage to already tarnished reputations, Roberts’ is focused on driving continual innovation with a promise to service both past and present implant recipients, underlined by the company’s life-long commitment to them - *“Hear now. And always.”*

“We are positioning Cochlear for sustainable growth. There is a huge unmet clinical need for our products...we are implanting less than 10% of the new people we could each year.”

Table 3 provides a brief summary of the group’s implant milestones since first gaining regulatory approval in 1985. Today, of the roughly 225,000 global implant recipients, Cochlear is estimated to have implanted around 160,000, representing a 70% market share. However in the wider context of the clinical market this is but a drop in the ocean. It is estimated that the market for patients suffering from profound hearing loss (90 dB or more, noise that is equal to a chainsaw) totals some four million while in the severe hearing impaired market (75-90 dB, equal to a baby crying, telephone ringing) sits a population group upwards of ten million.

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Within this group stand the addressable market, being those candidates who meet the implant criteria, have access to proper funding and who are willing to undertake the surgery and rehabilitation process. While this number is estimated to exceed 300,000 in the developed world (UBS broker research), Cochlear was responsible for implanting 21,000 of the nearly 30,000 undertaken during 2010. On these numbers alone, you can certainly understand why CEO Roberts remains decidedly upbeat on the industry’s long term prospects and that of the company’s.

This is not to suggest that Cochlear is without risk, evidenced by the mishaps that have befallen both competitors Advanced Bionics and Med-El. While the Cochlear implant has been refined and the manufacturing steps improved upon since the first implant twenty-eight years ago, there is no escaping the fact that unfortunate incidents sometimes occur. However unlike a drug, whereby the side effects may not be truly understood until a considerable period of time elapses, medical devices and their benefits should actually improve with the passing of time, as each generation of new product supersedes previous versions.

Table 3: Cochlear implant milestones 1967 – 2010

Year	Event
1967	Research initiated.
1978	First Cochlear implant (CI).
1981	Cochlear established as a division of Nucleus
1982	First commercial 22 channel Nucleus Cochlear implanted in Graham Carrick.
1983	USA Food & Drug Administration (FDA) approves adult Investigated Device Exemption (IDE) for clinical trial.
1985	FDA grants Pre-Marketing approval (PMA) for adults.
1986	First Nucleus 22 cochlear implant released.
1988	1,000 th patient implanted
1990	FDA grants Pre-Marketing Approval (PMA) for children.
1992	5,000 th patient implanted.
1994	10,000 th patient implanted.
1995	Cochlear (COH) lists on ASX December, issuing 50 million shares @ \$2.50 per share.
2002	Nucleus 24 Contour Advance implant introduced.
2003	50,000 th patient implanted.
2005	Nucleus Freedom processor released.
2005	Acquires Entific Medical Systems AB, manufacturer of BAHA bone conduction implants for net A\$175m.
2007	100,000 th patient implanted.
2009	COH Nucleus 5 system approved.
2009	COH Hybrid system under controlled release across Europe.
2010	First human implant expected for DACS (Direct Acoustic Cochlear Stimulator).
2010	Cochlear moves into new custom built headquarters located within Macquarie University.
2010	Cochlear exceeds 20,000 implants for the year and now totals over 158,000 since first gaining approval.

The Nucleus 5 implant for example is as noted earlier, 40% thinner and two and half times stronger than the earlier Nucleus Freedom implant released by the company in 2005. The fact that Cochlear has been able to sustain and grow its market share while continuing to deliver new and innovative implant devices underlines the group's real competitive edge - that it has been able to build a much better hearing implant device than many of its competitors.

Table 4 provides a snapshot of the group's financial performance since listing in 1995. The numbers are impressive as are the growth rates achieved, including compound growth rates over fourteen years of 15.6% and 18.3% for implants and net profits respectively. Starting off in 1995, it would have been difficult to imagine the level of acceptance the Cochlear product would have attained fifteen years on.

Cochlear now sells in over one hundred countries compared to the forty eight at the time of its listing. The product suite is now significantly larger, extending beyond the

traditional Cochlear implant to include newer technology offerings, including the Cochlear Hybrid system, which is the world's first integrated hybrid hearing solution, combining the benefits of a cochlear implant and hearing aids technologies.

Table 4: Cochlear track record of earnings

	CAGR 14 yrs	2010	2005	2000	1996
Cochlear Implant Sales (units)	15.6 %	21,023	10,802	4,941	2,756
Total revenue (\$m)	18.0 %	734.8	349.0	144.2	72.3
R&D expense (\$m)	16.6 %	94.9	44.6	20.9	11.0
EBIT (\$m)	22.2 %	220.5	82.5	30.4	13.3
Net profit (\$m)	18.3 %	155.1	59.6	20.2	14.8
EPS (cents)	19.9 %	275.7	110.1	39.6	21.7
DPS (cents)	21.9 %	200.0	80.0	30.0	12.5
Closing Share price (\$)		70.80	39.20	28.76	3.40
Market Capitalisation (\$m)		4,119	2,123	1,469	170
Issued Capital (m)		56.5	54.3	51.1	50.0

Industry's best electrode array for richer, more true-to-life sound



LIMITLESS CAPACITY
The Nucleus 5 Cochlear Implant is built with the most advanced chip technology available today. Excess chip capacity is built in so you can easily upgrade without additional surgery to newer technology and take advantage of future innovations that are constantly being researched.

MOST TRUE-TO-LIFE SOUND
The most electrodes - 83% more **real** electrodes* and the industry's only custom chip. Research shows that with the 22 electrode array, listeners could distinguish an average of 161 intermediate pitches.^{15,16}

MOST NATURAL FIT
Only Nucleus 5 has an advanced self-curling electrode array designed to naturally conform to the curve of the cochlea providing more precise stimulation of the hearing nerve for richer, more natural sound.¹⁷⁻²⁰

MRI FRIENDLY
The Nucleus 5 Cochlear Implant is safe for MRI scans up to 1.5 Tesla with the magnet removed.

MOST RELIABLE
Proven #1 in long-term implant reliability.⁶⁻¹¹

INDUSTRY'S THINNEST
The industry's thinnest titanium implant - 40% thinner than our previous generation and 30% thinner than any other titanium cochlear implant.

* When compared to a 12 electrode array.

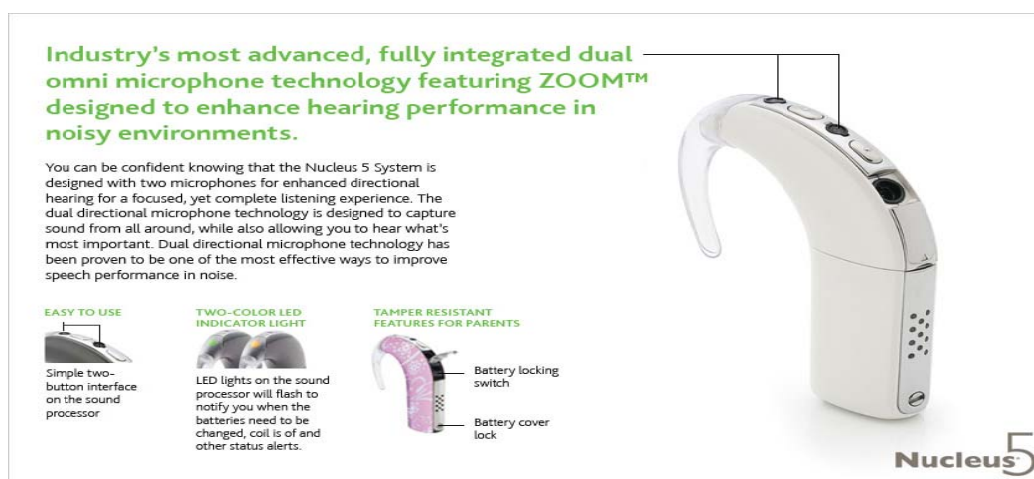
Nucleus 5

The fact that Cochlear has prospered to the extent that it has speaks volumes to the durability of the company's market position. As to the company's future, we have provided a "what if" scenario in **Table 5**, whereby we extend the growth rates achieved during the first 14 years for the next 5 and 10 years respectively. When presented in this context, what becomes quickly apparent is the magnitude of the numbers involved even for what are relatively short periods of time.

No doubt putting some workings into a spreadsheet to determine an outcome is a far easier exercise than actually delivering on those targets. Whilst it doesn't allow for any major disappointments, when looked at in the cold hard light of the company's endeavours to date, the projections regarding cochlear implant units and revenues five years out don't look entirely outrageous. However, trying to maintain that trajectory ten years out would certainly require a greater leap of faith.

Table 5: What if? - Cochlear thinking about earnings potential

		Now	5 years out	10 years out
	CAGR (%)	2010 (a)	2015 (e)	2020 (e)
Cochlear Implant Sales (units)	15.6	21,023	43,399	89,593
Total revenue \$m	18.0	734.8	1,681	3,845
R&D expense \$m	16.6	94.9	204.5	440.8
EBIT \$m	22.2	220.5	600.8	1,637.3
Net profit \$m	18.3	155.1	359.4	832.6
EPS (cents)	18.3	275.7	639.0	1,480.1
DPS (cents)	18.3	200.0	463.4	1,073.7



CEO Chris Roberts has laid the ground work for this impending growth, underpinned by excellent technology and a product suite that captures a broader share of the hearing impaired market. The new facilities pictured below is indicative of the confidence management has in delivering on these goals, while the competitive position it has earned, places the group in a powerful position to deliver. Time will tell whether the company can execute to the level reflected in **Table 5**, however a wonderful product suite, an enviable track record and a growing addressable market for implants provides some confidence that these lofty targets are possible.



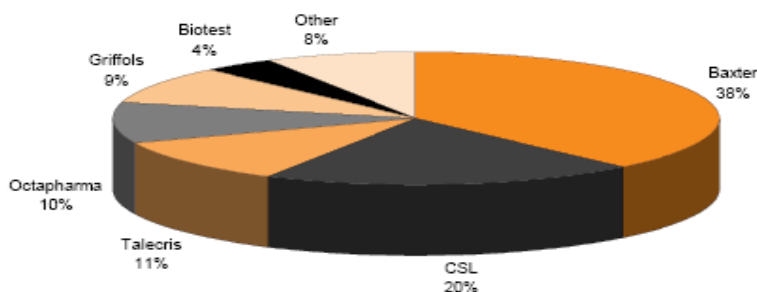
Hearing Precinct – Cochlear's New Global Headquarters located within Macquarie University

2. CSL (CSL)

Rising business barriers have also emerged in another important pharmaceutical arena, that of blood plasma manufacturing. In this case, CSL, one of the world's largest player's looks set to benefit from the recent actions of competitor Octapharma to voluntarily withdraw its blood plasma product, "Octagam" from the market. The initial withdrawal announced in late August 2010, has since expanded to include a complete product recall in both the US and European markets. As **Chart 1** illustrates, Octapharma is one of six major global players in blood plasma production, with a market share of 10%, lagging industry leaders Baxter and CSL with 38% and 20% respectively.

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Chart 1: Global Plasma Sales Market Share



Source: Company data, RBS forecasts

As we touched upon in our September 2010 quarterly newsletter, a series of well executed acquisitions over the past decade now has the former Commonwealth Serum Laboratories of Australia, renamed CSL, boasting one of the world's largest and most efficient plasma collection networks.

Broadly speaking, blood is made up of red cells and plasma, whereby the latter, separated from the blood via a process known as fractionation, leads to the collection of specific proteins that are used to treat a number of life threatening conditions including immune diseases, bleeding disorders such as haemophilia and in critical care situations .

CSL's real competitive edge has been its ability to maximise the revenue from every litre of plasma collected while minimizing waste, known in the industry as increasing the yield. From each litre fractionated, CSL is able to extract up to 23 different plasma products to treat the roughly 200,000 patients globally, that suffer from some form of immune deficiency. However, since the patient numbers for some diseases are so small, the number of products fractionated drops with each litre of plasma processed, giving the group a distinct advantage over other operators who are restricted to a few core plasma type products. At the same time, the high capital nature of the industry and the increasing regulatory barriers has led to a significant concentration of power among the few global blood plasma fractionators. Specifically, from 1984 to 2005 the number of fractionation plants in Europe and the US has declined from a combined 71 to 37.

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In the case of Octapharma, the recall of plasma derived products followed increased reports of safety concerns surrounding thromboebolic (blood clotting) events, commonly associated with stroke and deep vein thrombosis. The difficulty here is that having withdrawn the product, management needs to now pinpoint the area of manufacturing concern and conclusively show the regulatory authorities that the situation has been addressed. Industry analysts suggest that due to the seriousness of events such as these, authorities would need to undertake a revalidation of manufacturing procedures, a process likely to take twelve to eighteen months.

In the meantime, the benefits that will flow to the remaining players are twofold. Firstly, it will alleviate any concerns regarding over supply and secondly, increase pressure on existing Octapharma customers to seek alternative supply arrangements. At the very least, any exclusive supply arrangements will be replaced with multiple supply agreements, with both Baxter and CSL the likely beneficiaries.

Since its listing in 1994 at the issue price of \$2.30 per share (equivalent to 77 cents adjusting for the 3:1 share split in 2007), CSL has been led by its current CEO Brian McNamee. The company has side stepped many of the issues that have plagued other competitors, building scale, reinvesting aggressively into new facilities and developing improved products across the group's comprehensive product line up.

In particular, the US FDA approval in 2007 of antibody product Privigen, best typifies the CSL mode of operation surrounding research and development spend. While improving the yield from each litre of plasma is an ongoing primary driver, label claim extensions and improved user friendly products are as important in extending the company's competitive edge. In the case of Privigen, it offers patients the only antibody product on the market that requires no refrigeration. As a result, Privigen sells for about US\$64 a gram, a 20% premium to the group's existing antibody product Carimune, with approval now also granted throughout Europe and Australia.

Similarly, in March 2010, CSL was granted FDA approval to market new antibody Hizentra, one that can be administered subcutaneously (just under the skin) as opposed to the typical intravenous therapy (into the veins), that requires patients to visit hospitals for treatment. Its unique protein properties have set a new benchmark within this product category with European approval expected in 2011.

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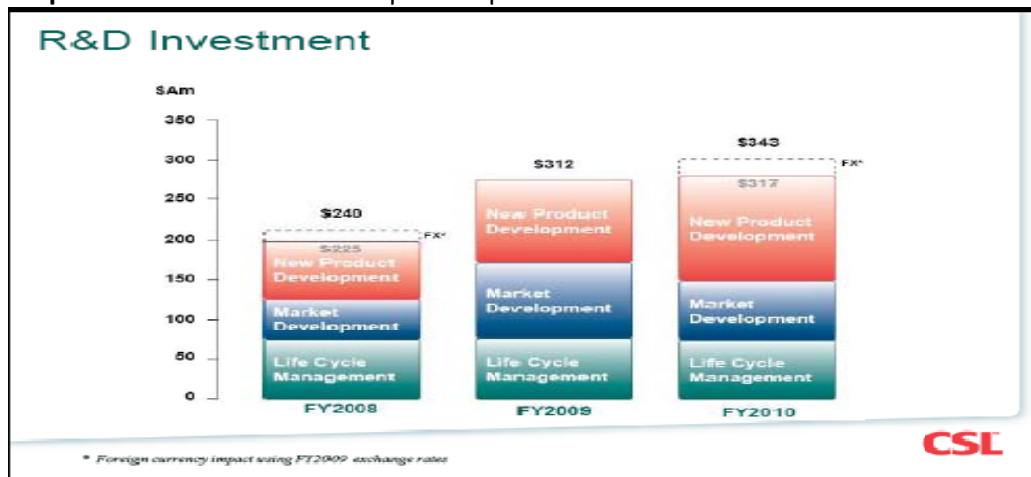
Many of these developments were discussed during the group's annual research and development (R&D) day. We have attended the conference for the past three years, coinciding with our initial investment in the business during the global financial crisis fallout in November 2008. While the conference showcases the breakthrough medicines under development, in the near term, management's absolute focus is on expanding the group's core franchise as depicted in **Graph 2**.

Graph 2: CSL research and development focus



On this front, the 800 strong R&D team, led by chief scientific officer Dr Andrew Cuthbertson is extremely excited about the group's late stage development program as it aims to expand the country reach and medical use of established protein medicines. **Graphs 3 and 4** sets out the R&D spend over the past three years giving rise to a plethora of new and emerging medicines as noted in **Graph 4**.

Graph 3: CSL research & development spend 2007-2010



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Graph 4: CSL Pipeline of new medicines

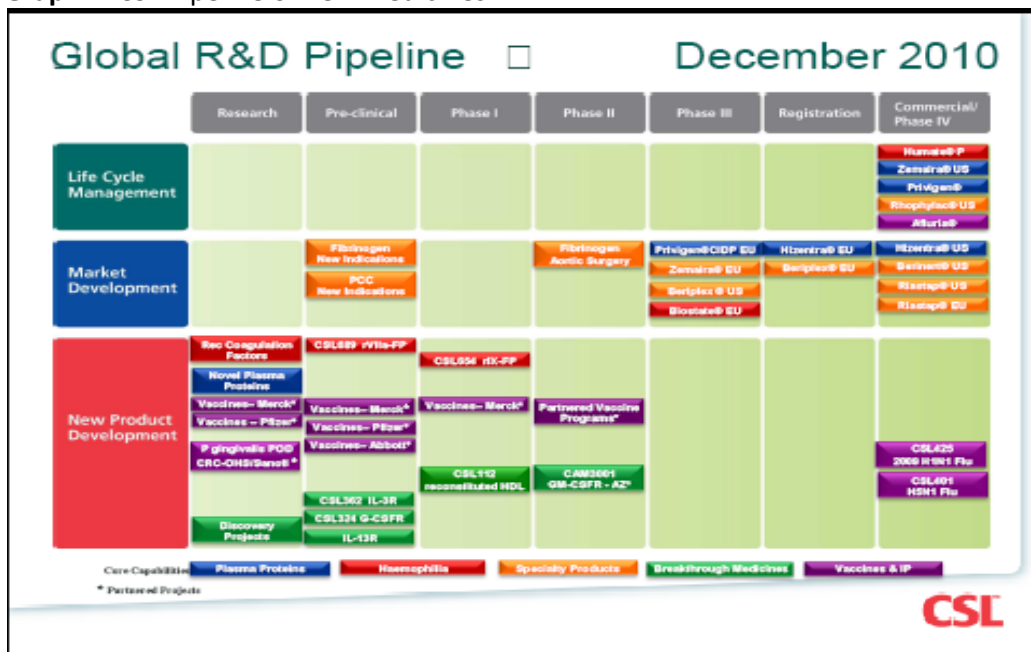


Table 6: CSL Track Record

	CAGR 15 yrs	2010	2005	2000	1995
Sales revenue (\$m)	21.2 %	4,456	2,750	451	250
R&D expense (\$m)	18.0 %	317.0	146.0	43.6	27.1
EBIT (\$m)	27.0 %	1,357.1	683.6	77.2	33.2
Net profit (\$m)	27.0 %	1,052.9	546.5	54.4	24.5
EPS (cents) *	25.6 %	192.0	0.93	13.6	6.3
DPS (cents) *	22.1 %	80.0	0.19	7.7	4.0
Closing Share price (\$) *		32.58	11.24	11.01	0.98
Market Capitalisation (\$m)		17,909	6,609	4,406	383.0
Issued Capital (m) *		549.7	588.0	400.2	390.0

* Figures adjusted for 3:1 share split undertaken October 2007

Unlike Cochlear, we don't expect CSL's future earnings profile to keep pace with its most recent past. The sheer scale of its operations and significant global market penetration suggests that a lower level of sustainable growth is more likely. That said, the group's PER multiple is no longer sitting above fifty, as was the case during the early part of this decade. Today, with the headwind of the strong Australian dollar and with investors pencilling in a more subdued outlook, the PER has retreated and sits below the twenty times mark. While this may not to be an absolute bargain, CSL's debt free balance sheet (net cash of \$540m as at June 30) places the group in a wonderful position to exploit opportunities as and when they become available. In the meantime, a dedicated commitment to product development has them ideally placed to build upon their market share.

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As Porter noted, the barriers to entry is the heart and soul of why some businesses are more durable and therefore more valuable than others. The recent product recalls from competitors Advanced Bionics and Octapharma has shed a more favourable light on both Cochlear and CSL. This may not always be the way but we have sufficient confidence that these businesses, run by two very experienced management teams, possess both the form and the substance to maintain an ongoing competitive edge for many years to come. *SFM*

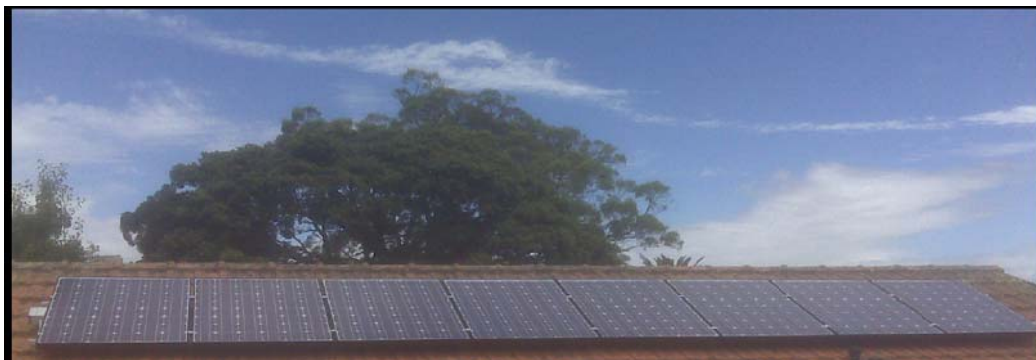
Small-scale renewable energy – case study revisited

In our December 2009 quarterly newsletter we reviewed in detail, two case studies on the renewable energy market, focusing specifically on how environmentally generated power, when combined with new technology and assisted by government subsidies made for a compelling business case. In fact the returns generated were made very attractive courtesy of the government's generous feed-in-tariffs.

As things would have it, the economics of the proposal became so compelling during the year that one of us took up the offer to install the solar photovoltaic panels during the last month of the quarter.

Having selected Origin Energy as the provider, the 1.5kW roof system comprising of 8 panels was duly installed without fuss. It now sits atop our roof (see photos below) although the final connection into the local electricity grid is awaiting a new meter, delayed due to the unprecedented public demand for solar units.

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As to the numbers, **Table 7** outlines the Origin proposal and the final cost to the owner. As you will note, the 8 solar panel Sharp units had a gross invoice purchase price of \$9,190, subsequently reduced to a net cost of \$2,990, once the renewable energy certificates (REC's), as allowed under current legislation, were forward sold to Origin, resulting in a \$6,200 credit to the owner.

In addition, the feed-in tariffs (price received from the electricity retailer for each kWh of power fed into the local power grid as per NSW government legislation) was set at 60¢ per kWh. Fortunately, the owner made the cut-off date to receive this generous offer, which has since been reduced to just 20¢ kWh.

Table 7: Origin solar electricity offer

Origin 1.5Kw solar system	Cost
Cost of Panels (8 panels / Sharp) & inverter	\$8,354.55
Roof Area (15 sq m)	
GST	\$835.45
Total Invoice purchase price	\$9,190.00
Less REC's assigned to Origin (155 REC's @ \$40 each)	(\$6,200.00)
Net cost payable by owner	\$2,990.00*

* 10% upfront (\$299.00) plus 24 equal monthly installments of \$112.12 interest free

With the owner facing a yearly electricity bill of about \$2,200, the benefit that this tariff is expected to deliver over the contractual period of six years ending December 2016, is in the range of \$1,000 to \$1,560 per annum. Even the lower figure of \$1,000 per annum, would result in a three-year payback period on the net purchase cost for the system, which well and truly justifies the investment. Importantly, while the economic incentive to install renewable energy was critical in the final decision to proceed, it has had the desired spin-off effect in this owner's household, that of changing daily energy habits to reduce the cost even further.

As an aside, while the economic incentive to install solar panels has been impacted by the government's recent action to cap solar demand, the actual dollar cost for a 1 kW system continues to drop from \$13 per watt before 2007 (equal to \$13,000 for a 1 kW system) to the current price of \$6 per watt (\$6,000 for a 1 kW unit). *SFM*

National Broadband Network (NBN Co)

Finally, the public have been given an insight into the Federal Government's thinking in regards to the implementation of the National Broadband Network, more commonly referred to as NBN Co. Following passage through the parliament to allow for the structural separation of the Telstra wholesale network, NBN Co released in December, a heavily edited 160-page business plan to justify the expenditure and merits of the new network.

Rather than reviewing the broadband plan in detail, the following comments aim to summarise what we see as the bullet points, noting that the expected social benefits to flow would need to be significant to justify, what appears to be very aggressive business assumptions.

When the Government first touted the project in April 2009, a \$43 billion price tag was the common figure bandied around, accompanied by an eight-year rollout timetable and aims to partially privatise the network within five-years of starting the build. Today, that figure starts at \$41 billion, made up of Government funding totalling \$27.5 billion and externally sourced borrowings making up the balance of \$13.4 billion. The Government is also paying Telstra \$9.0 billion plus another \$2.2 billion, to decommission its copper network, so as to remove any competitive wholesale tension. This extra \$11.2 billion is not considered a cost by the Government but more of an operating expense. However if you took the more conservative line, this adds up to a total outlay of \$52.1 billion.

The timeframe to build is now ten years and there is no talk of privatising this asset anytime soon. Being a rollout, the numbers start small and end up being big. The plan outlines the funding requirements to peak by 2020, when the network is expected to be completed while external borrowings of \$13.4 billion are not required before 2015.

Like any business plan, it all comes down to the assumptions relied upon as to whether the plan stacks up. In the case of the NBN, the 30 year business plan has all the pitfalls and potential cost blow outs one would imagine with a project of this scale and complexity. However in our opinion, the biggest risks are the assumptions regarding the public take up of the service and how changing technologies may impact on this.

In order for the Government to argue that this outlay of public funds is of an expenditure nature rather than a capital outlay and thereby keeping it off the

Budget, it needs to show that a commercial return can be generated. The Treasurer Wayne Swan has made it crystal clear that the priority of this Government is to return the Federal Budget to a surplus by 2013 and to achieve this, the NBN business plan must stack up commercially.

On the numbers presented, the NBN will aim to deliver a return of 7.04% on the capital invested over the 30 year life of the business plan and compares to the current risk-free ten-year government bond rate of 5.4%. Hardly a decent return, considering both the sums involved and time invested.

In fact, it only just crosses the commercial line because the plan extends out to 30 years. The Australian newspaper feature article on 21 December 2010 summarises the situation rather well;

“According to the projections, NBN will not make a profit of any kind until 2018, will not be profitable after paying its interest bill until 2020 and will be cashflow negative until 2021. But from 2021, when its capex task is largely completed, watch out, this thing becomes a cash machine.”

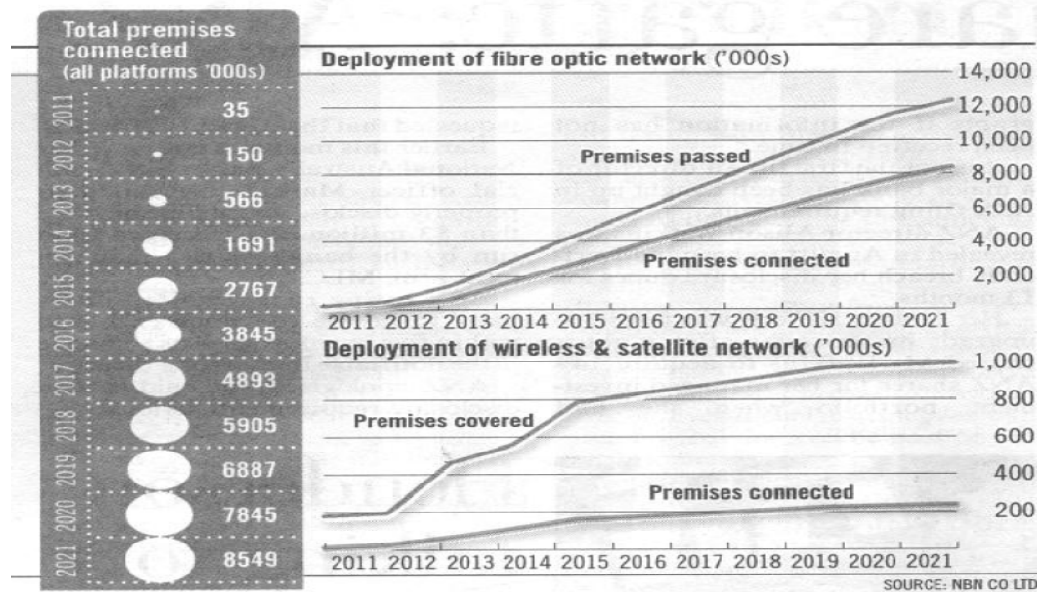
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By 2040, NBN’s \$14bn in revenues will be throwing off EBITDA of \$11bn and EBIT of \$9.3bn, which works out to a profit of nearly 80¢ in the dollar before depreciation, tax and amortisation. They are all very, very exciting numbers. But come 2040, when everyone will have forgotten what it cost to build our fibre beast, you’d have to ask whether that level of profitability will be politically sustainable. Imagine if Telstra was a protected monopoly and able to make these sorts of sums in any year, what would the world outside of the shareholders say?

That might explain why the NBN Companies Bill contains a regime for the possible future functional separation of NBN Co and why NBN’s corporate plan steps quietly through the necessity of retaining the integrity of the business as proposed.”

Yes that’s right, create a new monopoly provider so that one day down the track it can be broken up all over again. Without the ability of being the sole fixed-line wholesale provider of telecommunication services, the plan would have had no chance of getting up. And it is here that the big assumptions are made, starting with the take-up rates of 70 per cent for its high speed broadband services and only 4.6 per cent of premises (representing about 600,000) being served by non NBN fixed networks by 2025. As **Graph 5** illustrates, by 2021, the plan assumes that 8,549 premises of the nearly 12,213 in total, would have connected to the fibre optic network.

Graph 5: NBN fibre optic network take up assumptions



Secondly, despite the Government becoming a new monopoly provider of fixed line services, it does not stop competition from wireless broadband suppliers using mobile spectrum. Here the NBN plan makes the very courageous assumption that only 16.3 per cent of homes will be wireless by 2020, up from the current 13 per cent. If the take up rate is any higher, it most likely comes at the expense of the fixed network operator.

Finally, the economics of all this comes down to the prices consumers have to pay to access the service. On this score, the plan estimates that consumers could pay between \$53 and \$58 per month for a basic internet service, based on a national wholesale price of about \$24 paid for by the likes of Telstra, Optus and other resellers of telecom services. Hardly a great deal for consumers when you consider the competition that currently exists in the market place.

In fact, our last comment is reserved for the competition watchdog the ACCC. Having doggedly chased Telstra over access pricing, it now finds itself in the very unusual position of passing judgment over the Government's wholesale pricing offer. However, the key difference this time around, is that it now has the powers to issue "binding determinations" rather than "indicative prices" as was the case under the previous Telecommunications Act. As such, the ACCC could force the hand of NBN to lower wholesale prices, so as not to abuse its monopoly position. But to do so would risk the economics of the NBN business plan. How ironic would that be, for all those long suffering Telstra shareholders? *SFM*

Company visit diary December Quarter 2010*October*

NAN	Nansonics management meeting	05/10/10
SRX	Sirtex Medical management meeting	06/10/10
N/A	Iceutica IPO presentation	12/10/10
CSL	CSL annual meeting	13/10/10
TSI	Transfield Services Infrastructure Fund annual meeting	13/10/10
PXS	Pharmaxis Q1 quarter conference call	14/10/10
ARP	ARB Corporation annual meeting	14/10/10
COH	Cochlear annual meeting	19/10/10
PXS	Pharmaxis annual meeting	20/10/10
TSE	Transfield Services annual meeting	21/10/10
BKL	Blackmores annual meeting	21/10/10
ALL	Aristocrat Leisure investor open day	25/10/10
BBG	Billabong International annual meeting	26/10/10
SRX	Sirtex Medical annual meeting	26/10/10
CTD	Corporate Travel Management IPO	21/10/10
WOR	WorleyParsons annual meeting	21/10/10
PXS	Pharmaxis investor day	27/10/10
RMD	Resmed Inc Q1 conference call	29/10/10
WHC	Whitehaven Coal annual meeting	29/10/10
RVA	Reva Medical Inc IPO	29/10/10

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November

NWS	News Corporation Q1 conference call	04/11/10
PTM	Platinum Asset Management annual meeting	05/11/10
COH	Cochlear UBS conference	08/11/10
BKL	Blackmores UBS conference	08/11/10
SIP	Sigma Pharmaceuticals UBS conference	08/11/10
EPW	ERM Power IPO presentation	10/11/10
PAB	Patry's management meeting	10/11/10
CXS	Chemgenex Pharmaceuticals life science conference	11/11/10
BNO	Bionomics life science conference	11/11/10
IPD	Impedimed life science conference	11/11/10
BIT	Biotron life science conference	11/11/10
NAN	Nansonics life science conference	11/11/10
PXS	Pharmaxis life science conference	11/11/10
CAB	Cabcharge Australia annual meeting	17/11/10
WHC	Whitehaven Coal UBS coal conference	17/11/10

AZT	Aston Resources UBS coal conference	17/11/10
GNM	Gujarat NRE Coking Coal UBS coal conference	17/11/10
NEC	Northern Energy Corporation UBS coal conference	17/11/10
WEC	White Energy Company UBS coal conference	17/11/10
LNC	Linc Energy UBS coal conference	17/11/10
GBG	Gindalbie UBS iron ore conference	17/11/10
CFE	Cape Lambert Resources UBS iron ore conference	18/11/10
MMX	Murchison Metals UBS iron ore conference	18/11/10
CXD	CathRx annual meeting	19/11/10
CFE	Cape Lambert Resources management meeting	19/11/10
MSB	Mesoblast life science conference	24/11/10
POH	Phosphagenics life science conference	24/11/10
CPB	Campbell Brothers HY11 results presentation	30/11/10

December

N/A	Bioniche IPO management meeting	01/12/10
CPB	Campbell Brothers management conference call	02/12/10
CSL	CSL R&D investor open day	07/12/10
ORG	Origin Energy management meeting presentation	15/12/10
BBG	Billabong International trading update conference call	15/12/10
AGK	AGL Energy conference call	15/12/10
UBI	Universal Biosensors Inc. management meeting	20/12/10
CSL	CSL investor relations conference call	21/12/10
SLM	Salmat conference call acquisition	22/12/10

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