



**WE HAVE A  
NEW WEBSITE**

Tell us what you think for  
your chance to WIN a  
lunch with Geoff!

See page 19

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## Dear shareholder

Welcome to our latest investor newsletter.

Recently I watched the movie Social Network and was intrigued to learn that Facebook was established only 7 years ago. The latest valuation for the company is quoted at a staggering \$US82.9 billion. Some other interesting statistics are the average users age is 31, the average time spent on Facebook is 6 hours per day, there are over 600 million users of which 70% are outside the US and one of the fastest growth sectors is the 50+ age group. This showed me again how the business landscape continues to change and as fund managers we have to be consistently on the lookout for any change or trends that evolve so we can take advantage of them.

We would like to pass on our deepest, heartfelt wishes to the people affected by the recent floods, bush fires and cyclones in Australia.

We trust you enjoy this current edition and always welcome your feedback.

Regards

**Geoff Wilson, Chairman  
WAM Capital Limited**

# A message from the Board of WAM Capital

Over the past 11½ years, since listing in August 1999, WAM Capital Limited (WAM) has grown its market capitalisation by 6.1 times.

The objectives of the fund are to provide a growing stream of fully franked dividends, provide capital growth and preserve capital. During the 6 month period to 31 December 2010 the Board announced a 25% increase in the interim dividend. It was also pleasing that the fund increased 16.8% whilst having on average 53.3% of its assets invested in equities. Capital preservation throughout the GFC has been a focus, as shown in our 3 year performance of 6.0% per annum while the market fell 4.9% per annum.

Another objective of the Board and management is to continue to grow WAM while achieving the group's stated goal of delivering growth in the portfolio of approximately 15% a year over the medium term. Some years could see the performance exceed 15% while others, such as in 2008, the return may fall short. Since August 1999, the average performance before all fees and costs has averaged 19.5% a year.

The Board is committed to paying an increasing stream of fully franked dividends to shareholders provided the company has sufficient franking credits, and it is within prudent business practices. The ability to pay fully franked dividends every six months

has been made more obtainable by the Federal Government's decision in June 2010 to amend the Corporation Act regarding the payment of dividends. A company can now pay a dividend if the Directors believe the company is solvent according to the respective tests put in place. For WAM this should see the company pay a dividend every six months without having to worry about a market collapse such as in 2008.

In the 11½ years since it has been listed, the company has paid and announced in aggregate \$1.23 of fully franked dividends to shareholders.

Over the 11½ years WAM has paid income to shareholders either by fully franked dividends or capital return, on the initial IPO price at a minimum 8% per annum up to a peak payout of 16% per annum fully franked.

We would like to thank our shareholders for their continued support.

Regards,

Geoff Wilson, Matthew Kidman,  
Paul Jensen & James Chirside

*“The objectives of the fund are to provide a growing stream of fully franked dividends, provide capital growth and preserve capital.”*

## Performance

The gross portfolio increased 16.8% for the 6 months to 31 December 2010, while the S&P/ASX All Ordinaries Accumulation Index increased by 14.5%, the S&P/ASX Small Ordinaries Accumulation Index increased 29.9% and the S&P/ASX Small Industrials Accumulation Index increased 18.8%. The after tax NTA, adjusted for dividends, increased 11.9% while the share price, adjusted for dividends rose 30.0% for the 6 months to 31 December 2010. At 31 December 2010 equities made up 63.9% of the company's assets with the remainder in fixed interest and cash.

### Research Driven

The research driven part of the portfolio performed very strongly for the 6 months. The top performing research stocks for the period were McMillan Shakespeare, Reckon and Thorn Group. Opportunities for new investments were stronger when compared to the previous year with ten new positions purchased. These included Breville Group, RCR Tomlinson, ARB Corporation and Resource Equipment. We took the opportunity to take profits and exited our position in REA Group as it reached our target price. Positions were also exited in Sky Television Network, Thinksmart and The Reject Shop. Over the six months, a number of new investment opportunities presented themselves. This view is reflected in our cash levels which decreased from 56% as at 30 June 2010 to 36% as at 31 December 2010.

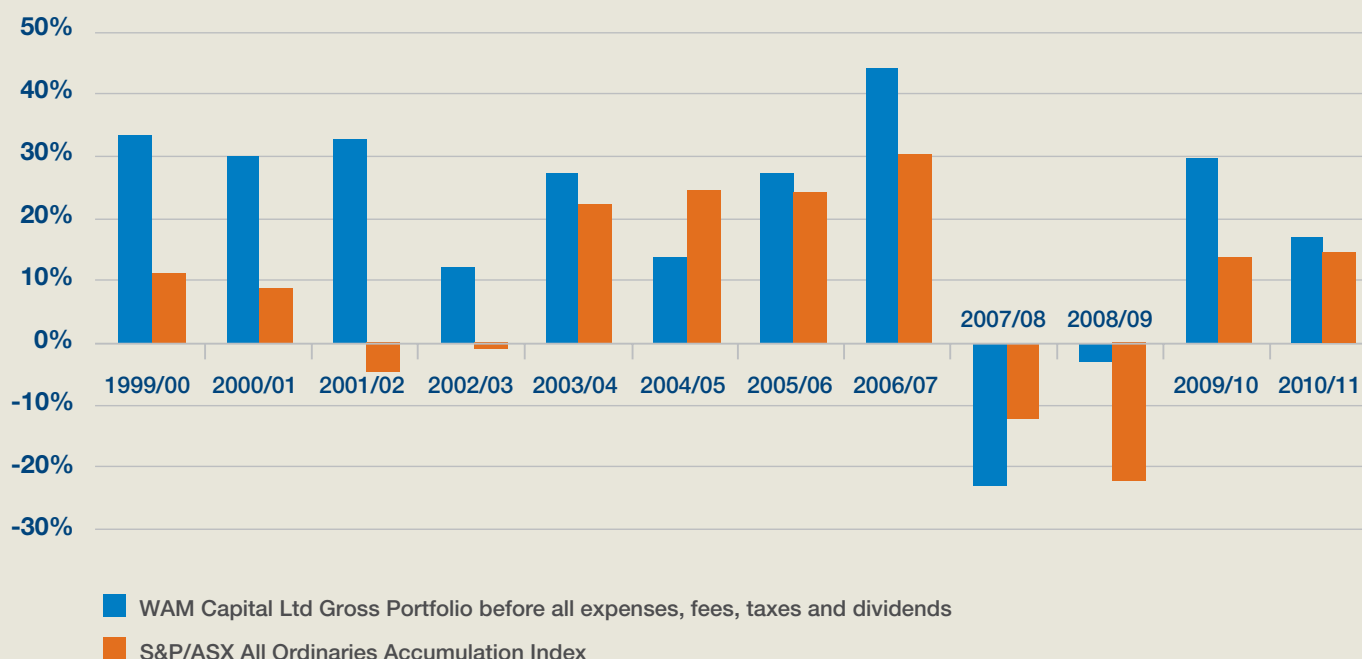
### Market Driven

The half was characterised by a plethora of capital raisings once again, predominately in the small resource sector which ran hot. For the six months the small resources index increased 47%, outperforming the S&P/ASX All Ordinaries Index by 33%. The Fund participated in 96 capital raisings. We expect these opportunities via capital raisings to continue for the rest of this financial year. Top performing market driven stocks for the six months included RHG Limited, Tower Australia and ITX Group.

Looking forward we expect a high level of M&A activity during 2011. Corporate balance sheets are in the best shape they have been in years, and if excess capital is not used for acquisitions, it will be used for capital management via special dividends or buy backs.

The Fund took advantage of several takeovers during the six months. These included Healthscope, AWB, Adtrans, Aevum and Ross Human Directions. An increasing theme are for takeovers to contain a fully franked special dividend component to the total proceeds being offered. As a Listed Investment Company, we put a high level of importance on these type of opportunities where franking credits are on offer.

### Annual Relative Gross Performance



# Dividends

On 10 January 2011 WAM announced a 25% increase in interim fully franked dividend to 5.0 cents per share to be paid on 11 March 2011.

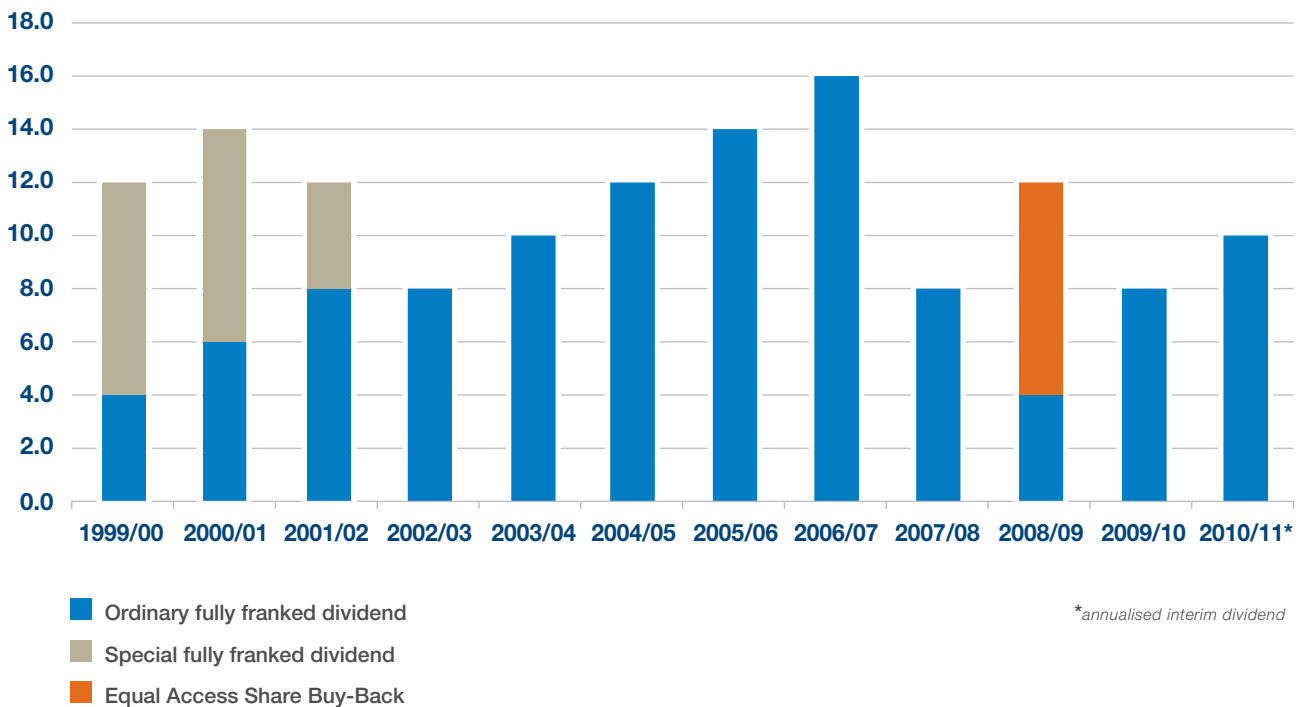
“Growing stream of fully franked dividends”

The Board is committed to paying an increasing stream of fully franked dividends to shareholders provided the company has sufficient franking credits, and it is within prudent business practices. Dividends are paid on a six-monthly basis.

Government legislation introduced in June 2010 now enables companies to pay dividends if the company is deemed solvent. Dividend payments will not be reliant on reported profit and retained earnings as it was previously. Rather, it will be with consideration to cash flow, cash holdings and available franking credits. Essentially, WAM will always be in a position to pay dividends providing it is solvent.



Cents per share



## Market wrap

The consensus among Australia's top share market strategists is the S&P/ASX All Ordinaries Index will rise approximately 14 per cent in 2011.

This number is based upon a survey in the Australian Financial Review on January 4 of the top 10 strategists in the local market. If proven to be correct this would mean we could expect a total return, including dividends, of close to 18 per cent which is well above the long term average of around 11 per cent. This bullish outlook is a significant improvement on 2010, which saw the S&P/ASX All Ordinaries Index track sideways before closing down for the year by 0.73 per cent. The market's performance in 2010 was characterised by a strong 10 per cent gain by the resources sector and a 7 per cent decline by the top 200 industrial stocks. The hottest sector for the year was the small resources sector which leapt 30 per cent, mainly in the last four months of the calendar year.

The 2011 bulls argue the year ahead should see solid gains based on reasonable stock valuations, continued strong demand for resources from South East Asia, in particular China, and an acceleration of the economic recovery is the US. All of these arguments are a continuation of the themes that dominated Australian markets from early July in 2010.

We are however much more circumspect. We agree that industrial stocks are reasonably priced at around 13 times forecast 2011 earnings, however, the prospect of higher interest rates through the course of 2011 could put a cap on earnings growth. If this is indeed the case, we will see little upside in share prices for industrial stocks coming from price to earnings multiple expansion. In fact, it is quite possible that multiples may contract if the Reserve Bank of Australia is forced to aggressively raise interest rates due to a tight labour market and a massive expansion from the resources sector. While a sharp hike in rates is unlikely, it cannot be totally discounted. The best result for the industrial market would be for official interest rates to be on hold for the course of 2011.

Other recent events that will impact economic growth in 2011 is the wide spread flooding and cyclonic activity. While the full effect of these natural disasters are yet to be known, estimates predict a loss greater than 0.5 per cent of GDP.

We also believe that China, the engine for above average world growth during 2010, may not provide such a buoy for the local economy in 2011. In recent months, the Chinese Government has been forced to lift interest rates and restrict lending practices to try and cool the economy. These measures have failed to have an immediate impact and inflationary pressures have emerged. As a result, China will be forced to keep raising interest rates, which should eventually ease inflationary pressures and ratchet down economic growth from over 10 per cent to possibly as low as 7 per cent. In turn, the much loved Australian resources sector, may find it difficult to repeat it's stellar performance of last year. If this scenario plays out, the Australian dollar may also retrace some of its substantial gains of 2010. This is not to say, the China economic miracle is over, but it may need to have a health check in 2011.

The prospect of the US economy continuing to recover in 2011 is more likely. Share market bulls are likely to be frustrated by the pace of the recovery given the moribund housing market. However, low interest rates should support economic growth of around 3 to 3.5 per cent for 2011. This may not lower unemployment dramatically but it will be supportive of company earnings and equity prices. Leverage to this recovery can be found in Australian listed companies that have major operations in the US.

*“ We believe the drivers of the market will change during the course of the year with the resources sector easing back, especially at the red hot small end of the market, while industrials, especially those with exposure to the US economy could perform strongly. ”*

All of these factors should see equities struggle to move significantly higher in 2011. We believe the drivers of the market will change during the course of the year with the resources sector easing back, especially at the red hot small end of the market, while industrials, especially those with exposure to the US economy could perform strongly. We have moved to position our portfolio to take advantage of this view.

# Investment Objectives & Process

Our investment objectives are to achieve a high real rate of return, comprising both income and capital growth, within risk parameters acceptable to the Directors and to preserve the capital of the Company.

Our investment process focuses on:

**(a) Research Driven investing:**

We undertake extensive research (over 700 company meetings each year), focusing on free cash flow then rating the company with respect to management, earnings growth potential, valuation and industry position. We only buy when we can identify a catalyst or an event that will change the valuation the market gives to the company.

**(b) Market Driven investing:**

We scour the market for trading opportunities. These could include participating in initial public offerings, placements, block trades, rights issues, corporate transactions (such as takeovers, mergers, schemes of arrangements,

corporate spin-offs, restructurings), arbitrage opportunities, LIC discount arbitrages or relative value arbitrages. This part of the portfolio is traded actively.

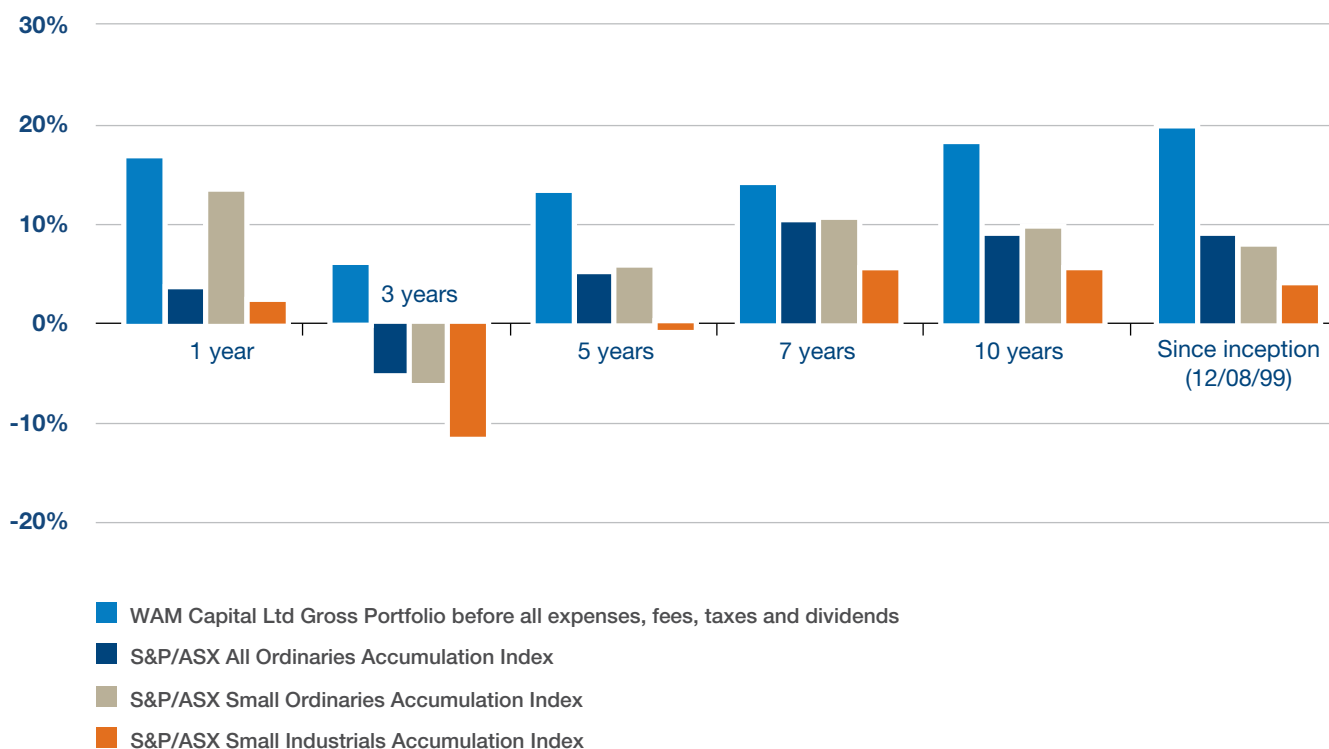
In the Research Driven part of the portfolio we do not favour investing in mining companies due to the high risk nature of mining businesses and the volatility of revenues. This does not apply to the Market Driven part of the portfolio where we are looking for trading opportunities.

**Risk Management**

WAM Capital has a low risk profile for a number of reasons. If the manager does not identify a catalyst under the Research Driven approach or a trading opportunity under the Market Driven approach we hold cash. The net cash

position over the last 11 years has been 29.8%. The company has no borrowings and has no intension at this stage to take on bank debt. It offers shareholders access to a diversified portfolio of shares with purchased positions of 3%, 2%, 1% or less. The company also has a low exposure to the resources sector because the Manager considers this sector is subject to extreme volatility and is difficult to value according to conservative accounting and investment principles.

## Annualised performance as at 31 December 2010



## What is a Listed Investment Company?

A Listed Investment Company (LIC) is a listed pooled investment vehicle that offers investors access to a diversified portfolio of shares in other companies also listed on the stock market.

The underlying portfolio offers investors a range of different strategies. A LIC is a company structure listed on the ASX just like BHP or CBA.

A major benefit of the LIC structure is that it is a closed end pool of capital. By closed end we mean that if an investor wants to leave the fund, he or she sells shares to another investor. This is usually done through a broker. Effectively, no money leaves the fund and only the shareholders change. This differs from a managed fund/unit trust structure, where an investor leaves the fund by redeeming units and withdrawing the money from the fund.

We believe that a closed end fund is a superior structure to a managed fund/unit trust structures. With closed end funds or LIC's, the manager of the fund does not have to sell stocks in the portfolio to raise cash for a departing investor. That means investment decisions are based on the fundamentals of the companies the manager invests in, rather than money flow via redemptions.

Most other funds, like managed funds and mutual funds, are open ended. This means that when an investor wants to leave the fund the manager is forced to liquidate stocks to finance the redemption. This places pressure on the manager who has to put fundamental investing to the side while he or she manages the cash flows. Invariably, most investors depart a fund when stocks have fallen significantly, which historically has proven to be the best time to buy. This means the manager may have to sell companies which they believe represent good value.

At the other end of the scale, most money pours into the market and open ended funds, when stock prices are soaring in a bull market. The manager of the managed fund may then be forced to buy companies at inflated prices due to their strict mandates. This type of momentum investing can cause a serious destruction of capital when the bull market ends.

As a LIC is a closed end fund it does not have any of these problems which can be of significant advantage and benefit to the investor.

LIC's are unique investment vehicles because they can trade at a discount or premium to the assets that they own. When investors want to take their money out of LIC's, selling may result in the share price falling below the value of its net asset backing (or NTA). We refer to this as trading at a discount to NTA. This can provide a great buying opportunity for investors. On the other hand, when investors are buying shares in LIC's, the share price may trade higher than the value of the assets it owns. This is referred to as trading at a premium to NTA. This can provide a selling opportunity for investors.

## What Wilson Asset Management offer to shareholders

### Style

- A flat structure that delivers quick decision making
- A nimble investment process due to the relatively small funds under management
- A broad coverage of market sectors, especially at the small to medium end of the market
- An aversion to risk with above average cash positions
- Over 50 years of experience in the Australian share market with a high degree of street smarts.

### Structure

- Closed end funds avoiding the problem of being forced sellers and buyers at inappropriate times
- An active research driven approach that involves staying very close to the market and an in depth analysis of investee companies
- An investment vehicle that delivers fully franked dividends.

# STOCK-MARKETS: Thinking generally... and particularly about 2011

By George Sutton of Ecinya ("we")

ECINYA is an acronym for Exercise Caution In Your Affairs and is meant to remind both you, and us, that in order to get rich quickly you should endeavour to get rich slowly, as all endeavours require appropriate management of risk, and time.

“I remember particularly a lecture in 1933 when he tried to convey how new ideas were born. Never did they arrive, he said, with the hard edges that later critics came to attribute to them when trying to define their terms. Ideas were likely to be like fluffy balls of wool with no fixed outline and the relationship between concepts when first perceived was likely to be equally woolly. Keynes distrusted intellectual rigour of the Ricardian type as likely to get in the way of original thinking and saw that it was not uncommon to hit on a valid conclusion before finding a logical path to it.”

Sir Alex Cairncross talking about 'Ideas' and John Maynard Keynes, circa 1936

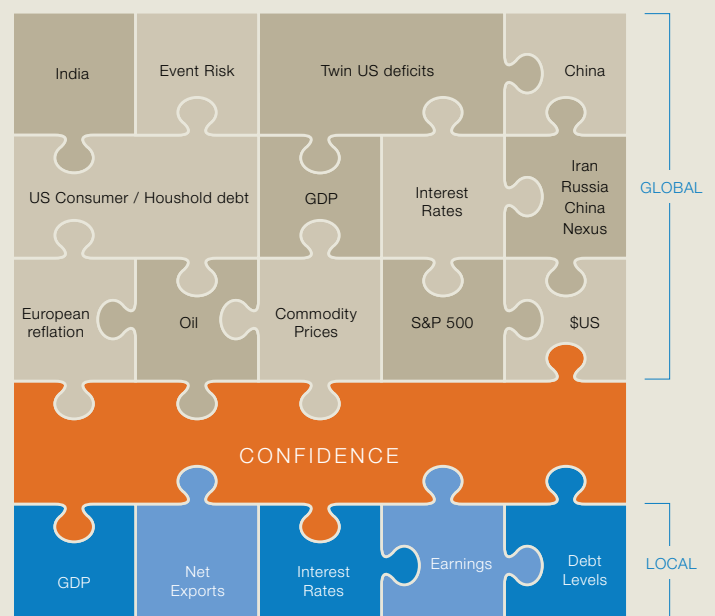
## KEEPING IT AS SIMPLE AS IS SENSIBLY POSSIBLE (our version of 'kiss')

The stock-market from time to time appears to be an easy endeavour, but neither the economic cycle or market cycle is dead, and profits won on one adventure can disappear in the next. Folly can easily follow triumph. Those that tell you the market is easy, 'either do not know, or do not know that they do not know' (J K Galbraith).

There is so much noise in the markets that it is often difficult to know what to think, where to start, who to trust, how to allocate your resources etc. We have thus enshrined in our thinking the acronym 'ICE'. This translates into Interest rates, Confidence and Earnings.

Interest rates gives us a yield to work off as well as being relevant to interest costs being incurred by companies which will impact their earnings. Confidence levels give us a guide to price earnings multiple expansion as there is a level of belief in how sustainable the earnings will be. And most importantly of all, the absolute level of earnings gives us a number to apply our multiple to.

But confidence is the dynamic that the markets have the most trouble with. In a 2006 presentation we drew The Market as a dynamic jigsaw:



What is interesting to us as we reflect upon the jigsaw is how little has changed in the puzzle pieces over the past 5 years. A few observations:

- India and China are still vitally positioned
- Event risk has not gone away and still cannot be measured
- The twin US deficits are unimaginably worse
- Household debt has been joined or given way to sovereign debt issues
- Europe is deflating now but will reflate in due course
- Iran is still a stand-out problem within the broader, deeper, wider Middle East discourse.

### SO LET'S THINK ABOUT 2011

Our real focus is stock selection against the background of micro company earnings forecasts and macro market and macro economic analysis. Technical and quantitative analysis provide confirmation or divergence from these deliberations. In index terms we focus on the All Ordinaries locally (XAO) and the SP500 as our global proxy (SPX on most systems).

**In our opinion 2011 will be a year of shadow and light, not unlike 2010.**

The SP500 finished 2010 at 1257. Our 2011 forecast expectations for the SP500 is that it encounters resistance around 1275 to 1290, then falls to around 1200. After that it rises about 15% to around 1380 and then falls about 15% to around 1180 before rising to finish the year at about 1320 for an overall gain of about 5%.

Our market in All Ordinaries terms is steady at around 4900 at the moment. We suggest that it will over the course of the year rise to about 5400 before retracing to around 4700 and finishing the year around 5100, up 5% year-on-year.

**Our hypothesis therefore is that overall the year will be essentially flat, but with sufficient volatility to allow traders and active value investors to out-perform market indices.**

There is always scope for over-and under-shoot but trend, bias and momentum are the phenomena needing to be observed for risk management and asset allocation decisions.

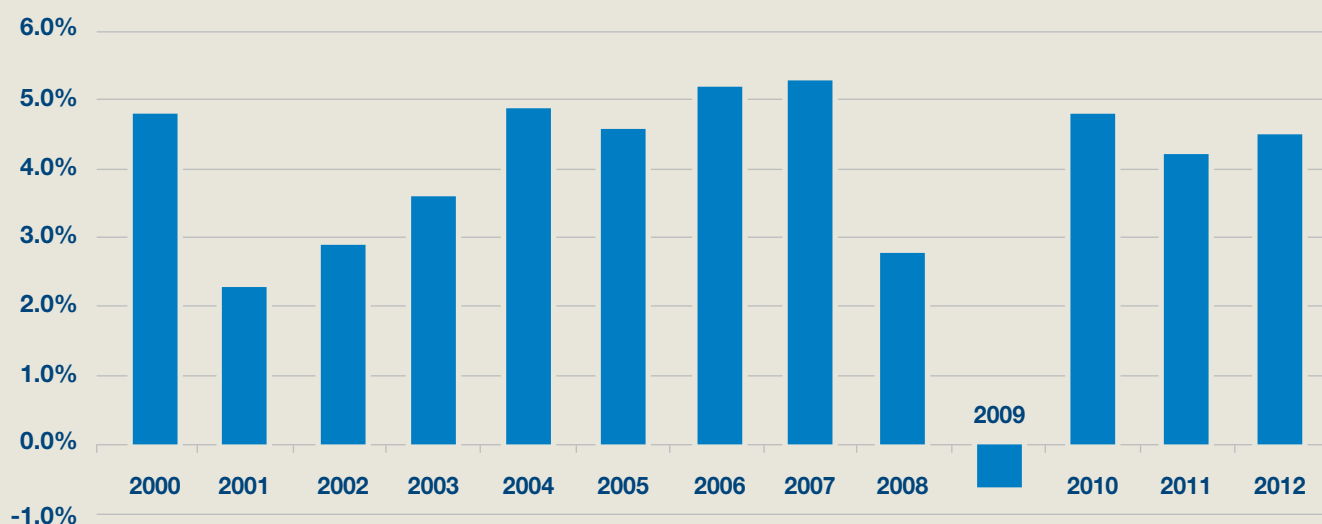
### A WORD ON FORECASTS

A forecast is a prediction and calculation related to future events. The future is difficult to predict both in relation to time and dimension. Therefore, the underlying hypothesis has to be set out so that as events unfold and time passes, the forecasts can be measured to provide confidence, or provoke action.

**An hypothesis is according to our Collins Dictionary “A suggested explanation for a group of facts or phenomena, either accepted as a basis for further verification or accepted as likely to be true”.**

The world was in recession for 2009 with world growth running at negative 0.6% according to the IMF. In 2010 their estimate is that the world will grow at 4.8% and at about 4.2% for calendar 2011.

## World GDP



Source: International Monetary Funds

STOCK-MARKETS: Thinking generally... and particularly about 2011

The market recovery from March 2009 was a renunciation and recognition that the world was NOT about to end. Too many of the world's bureaucrats failed to recognise that inappropriate fiscal and monetary policy was encouraging manipulation and exploitation of inadequate regulatory frameworks and this combination of factors would lead to an inevitable crash. Responsible persons and entities above the market were not moved to say "Stop, this has gone too far!" Current observations are that we have learned little from the last crash and previous episodes.

The 2010 year was driven by monetary and fiscal stimulus as "too big to fail" prevailed. "Too big" embraced both countries and corporations.

In 2011 we face the natural consequences of the actions that aided an economic and market recovery in 2010. The bullish hypothesis is that the emerging world (Asia and parts of South America) can take the developed world from survival to revival. Also that Ben Bernanke will succeed in stabilising the US economy to allow free enterprise to invest and borrow to create jobs. It is rather amusing that we hear the expression "jobless recovery"... how can you have a jobless recovery?

In Europe the approach has been that austerity is the path to prosperity. The PIIGS (Portugal, Italy, Ireland, Greece, Spain) have not gone away they are merely sleeping.

Australia went into the global financial crisis in good shape thanks to good government prior to 2007, China and commodity prices. However, over-reaction on the fiscal front to the GFC in early 2009 now leaves us more exposed, as so much of the fiscal policy resulted in waste, extravagance and fraud. Thoughtless politics got in the way of thoughtful economics.

On the American sub-prime fiasco It is interesting to reflect that home ownership which normally requires a job and the resulting income to repay a mortgage only required the existence of an aspiring home-owner and a glut of financial engineering. But then we pass this sub-prime event and the dot-com event off as 'bubbles' which both softens and trivialises the enormity of the travesty. It seems that too many of our global bureaucrats think that a university degree, briefcase and Armani suit plus a reading of Buffetology, business and economic history qualifies them to recognise and solve problems that impact on ordinary workers and taxpayers.

Though we got our 2010 market forecasts (XAO and SP500) near enough to 100% correct, our reasoning was marginally deficient in that the scale of the required stimulus was so large. It seems that the world is currently relying on fiat money to achieve survival and revival plus global excess capacity to mitigate inflation. Additionally, we find that our own forecasts whether accurate, or inaccurate, do not provide much in the way of a basis for constructive action over the course of a year in the stock-market.

We find the forecasts of others as quite useful as we know from experience that they will be either inaccurate, or extremely inaccurate, especially those of professional economists. People who forecast a year-end number for any economic or market indicator without a low forecast as well as an intermediate high, are adding little, or nothing, to your chances of matching or beating the market indices.

Recently, we re-visited the forecasts of 9 major players who on 4 January 2010 made forecasts for the top 200 (XJO). None were correct within a 3% margin of error. The best was wrong on the high side by 9% and the worst was 17% wrong on the high side. Updated forecasts for 2010 year-end were made by another group of 14 forecasters, inclusive of the original 9, on 2 July 2010. Only 3 were correct within a 3% error margin, which means that 11 were wrong. The largest error was 10%. And that was with half of the year gone and knowledge of their propensity for error given their six month earlier forecasts and the basis for them.

We see the 2011 year as having stronger elements of revival provided that government stimulus is constructively withdrawn. Using George Soros' word on reflexivity for a good part of the 2011 year the trend will be up and the bias will be supportive of the trend, but elements will emerge that give reason to focus on the possibility of a crash. Something more than a 10% retracement constitutes a 'crash' in our view.

## BACKGROUND TO OUR HYPOTHESIS

“All countries which accumulate debt and habitually run big current account deficits are vulnerable. And for many centuries societies have been susceptible to irrational booms, South Sea Bubbles, tulip bulb booms, and dot com busts. But no central bank can offset the cascading effects of bad government policy.”

Peter Walsh former Labor Party Finance Minister,  
Financial Review 10/12/2003.

“The principal contribution that monetary policy can make to economic well-being is to maintain low and stable inflation. I think it is true to say that if you wished to forecast the path of the Australian economy, and you were able to have fore-knowledge of only one economic variable, the one you would choose is the path of the world economy. That is not to say that we have no influence over our own destiny – we can make the situation better or worse than it would otherwise be – but we cannot escape the influence of the world business cycle and the other factors that feed off it.”

Ian Macfarlane, former Governor of the Reserve Bank,  
14/6/2005.

The background to our 2011 hypothesis of our reference markets (XAO and SP500) rising to a peak of about 15% before falling over to be essentially flat, is twofold.

Firstly, is our belief that government in the developed world has now become too big having moved to around 30% of GDP and is significantly over-leveraged for the very worst of reasons – to encourage their re-election. This applies in greater measure to America, but also in significant measure to Australia. Australia's march of folly has begun from a better base than in the USA.

The second plank to our hypothesis is that the symbol economy of money and credit is wagging the real economy dog of production of goods and services. Monetary policy cannot offset the cascading effects of bad fiscal policy. Ben Bernanke is not Charles Atlas carrying the weight of the world economy upon his fiscal fiat money shoulders.

**The March of Folly:** Barbara Tuchman wrote “The March of Folly (from Troy to Vietnam)” in 1984. Across the pages of a big slice of history she describes various events that lead to her opening paragraph:

“A phenomenon noticeable throughout history regardless of place or period is the pursuit by governments of policies contrary to their own interests. Mankind it seems, makes a poorer performance of government than almost any other human activity”.

The final paragraph in her book is clinically neutral and says:

“We can only muddle on as we have done in those three or four thousand years through patches of brilliance and decline, great endeavour and shadow”.

An intermediate paragraph that always captures our attention concerned the United States of America: “For two centuries, the American arrangement has always managed to right itself under pressure without discarding the system and trying another after every crisis, as have Italy, Germany, France and Spain. Under accelerating incompetence in America, this may change. Social systems can survive a good deal of folly when circumstances are historically favorable, or where bungling is cushioned by large resources or absorbed by sheer size as in the United States during its period of expansion. Today, when there are no more cushions, folly is less affordable.”

From Ms Tuchman's text immediately above the striking and agreeable words to us are “accelerating incompetence” and “when there are no more cushions folly is less affordable.”

STOCK-MARKETS: Thinking generally... and particularly about 2011

'Folly' in the Austrian school of economics is reflected in their focus on misallocation of resources. Economics teaches us that relative to wants and needs, resources are always scarce. 'Cushions' to us means things like balanced free enterprise with governments playing a role that guarantees or strives for integrity and transparency. However, as governments have become more opaque and less honest in their dealings with voters and taxpayers, the private sector has followed suit (especially large businesses) and become less opaque and less transparent itself for reasons of short-term profit maximisation and for survival.

Real reform is off the agenda until truth becomes politically fashionable and effective again. In the meantime we can rely on market trends being up for most of the year and the bias tending towards optimism. The Ninth Zurich axiom of Max Gunther says "*Optimism means expecting the best, but confidence means knowing how you will handle the worst. Never make a move if you are merely optimistic*".

### **ACCORDINGLY ECINYA'S AIMS FOR 2011 ARE:**

1. Preserve capital.
2. Lock in some of the gains from 2010 early in 2011.
3. Be more committed to fewer stocks over the course of the year knowing that stock selection is almost always vital. A few stocks that have the potential to surprise will be bought from time to time.
4. Be prepared to move quickly and aggressively into cash from time to time.
5. Pick some recovery stocks (eg. media, building materials are possibilities, banks, some retailers later in the year perhaps).
6. Pick some takeovers (Crane has been a good beginning, though we got the bidder wrong).
7. Double digit returns.
8. Out-perform the All Ordinaries by more than 400 basis points.
9. Have a good dividend flow.

### **WHAT DO YOU NEED TO DO TO ACHIEVE OUT-PERFORMANCE?**

We have long believed that out-performance can best be achieved by an investor learning to trade a reasonable proportion of his stake over the course of the year. The 'buy and hold' strategy is risky. The 'buy and sell' strategy is less risky. Our preferred approach is the 'buy and trade-around-the edges' of an investment portfolio which can be rewarding and can be fun. Occasional speculation is OK but do not confuse speculation with investment. Junior mining stocks look like an obvious bubble.

### **UPSIDE / DOWNSIDE**

The upside is always easily manageable, the downside less so. With upside you can go with the flow and try to not get too far outside beyond your view of what represents reasonable value. The downside requires much more effort and deliberation.

If good things happen then that is good news. If bad things do not happen then that is good news as well. Do not expect that progress will be linear.

### **EXECUTIVE SUMMARY OF THE CONCERNS SURROUNDING OUR 2011 HYPOTHESIS**

#### **Australian Concerns:**

- The current Queensland floods.
- Fiscal policy out of control and will get worse before it gets better, and may not get better at all in the life of the Gillard-Rudd-Greens coalition.
- China might slow down just enough to give us a dose of economic castor oil.
- Interest rates may stay uncomfortably high.
- Tax reform is off the agenda, pretend reform is on the agenda.
- Economic growth may be uninspiring below 3% in real terms.
- Policy positions on water management, electricity, climate change, national broadband, refugees, and welfare generally seem hopelessly inept.
- Lack of attention to small business.
- Political donations need to be banned and instead go into an electoral bank to be distributed on a formula basis. Too many cronies in the political ranks.
- The federal parliamentary term should be extended to 4 years with a minimum term of 42 months to give time for policy to work and/or be fine-tuned.
- Liberal Party provoking Labor into bad policy eg. the recent bank bashing exercise lacked perspective and balance.

**American concerns:**

- Crony capitalism has not dissipated under Mr Obama. Goldman Sachs, Bank of America, Citibank, and JP Morgan appear to be part of government providing personnel, market and donor support.
- The Federal Reserve is outwardly non-independent promising to 'print money' as long as it takes. We hope that behind closed doors they are somewhat more independent.
- Trends in the US domestic deficit and current account deficit. America can afford its deficits but not an acceleration in the current trend.
- Lack of employment policies though this may be remedied by a successful implementation of the Dodd-Hagel Infrastructure Bank Act.
- Lack of effective savings plans eg. compulsory superannuation Aussie style.
- House prices still in decline.
- Smaller commercial banks still being closed down.
- Large state and local government budget gaps. California appears to be insolvent.
- Energy prices still a problem.
- Paranoia over China leading to poor dialogue and lack of constructive communication.
- QE2? Where does it end?
- Need for structural reforms in taxation, probably a national sales tax.
- Continuing debate and lack of consensus and viability in health-care.
- Wall Street appears to have learned nothing from sub-prime and dot-com fiascos.
- Congressional grid-lock giving the impression that America is ungovernable.

**European concerns:**

- Germany appears to be the only European country with an established work ethic.
- Portugal, Italy, Ireland, Greece and Spain struggling on high sovereign debt loads.
- European response to austerity seems to be riots, looting and burning... hellishly unproductive.
- The Euro seems to be a constraint when countries cannot devalue their way to recovery.
- Euro area growth projected by the IMF to move from negative 4.1% in 2009 to positive 1.5-1.7% in 2011, a muted recovery.

**Asian concerns:**

- China inflation and consequent policy tightening.
- China to decide how it wants to become a fully fledged member of the global community.
- Over-simplification to regard China as a country of economic geniuses. That mistake was made when Japan was growing exponentially.
- Japan still in the doldrums after several decades.
- India inflationary concerns.

**Technical concerns/watch-list:**

- SP500 seems over-bought.
- Baltic Dry index, a reasonable proxy for world trade, is weak possibly indicating that China trade is weakening.
- The Shanghai A index is wilting.
- Chinese industrial production slowing.

**Geo-political concerns/watch-list:**

- North Korea
- Afghanistan
- Pakistan
- The middle east – Iraq, Iran, Israel, Palestine, Yemen, Egypt.

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George Sutton B.Ec (Syd), ACA, F Fin is an authorised representative of Ecinya Consultants Pty Limited and acts as editor of the Ecinya pages. George has been a former lecturer at The Securities Institute, a Corporate Finance Executive with two major investment banks, an analyst with BZW (formerly ABN Amro, now RBS) and then Managing Director of James Capel Australia. His major interests are the stock-market and golf – both mind games requiring technique, discipline, patience, and a sense of humour.

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## *A closer look at our holdings*

### STW Communications Group

(Research Driven)

STW Communications Group (ASX Code: SGN) is Australia's largest marketing communications group with over 70 companies in the group.



Some of its well known businesses are Ogilvy and JWT. The group has undergone a transformation over the period of the GFC. They have significantly reduced corporate debt on the balance sheet whilst maintaining >10% growth in the process.

The business floated on the ASX in 1994 and up until the early 2000's the stock traded on a high P/E multiple relative to the market. Over time and into the correction which commenced in 2007 this multiple contracted to an average of 8-10x P/E. We had followed the company for many years. The idea was put up for discussion in our weekly ideas meeting in July 2009. We had the view that STW would be a late cycle play. Marketing spend is typically the last expenditure that corporates re-activate as they gain more confidence in the economy.

Post our two initial meetings with the company's senior management in July and August 2009, it became clear to us that our thesis was playing out. Confidence amongst corporate Australia was gathering momentum and the pipeline for the advertising industry was improving.

We had confidence in the management team to deliver and viewed the appointment of Chief Financial Officer Lukas Aviani in December 2009 a positive for the group. Lukas introduced an increased transparency in reporting result to the market along with clarity around company earn outs. These earn outs were liabilities to vendors whose businesses they had purchased over previous years. Most importantly they were capped to the upside. i.e typically earn outs are linked to profitability post acquisition. Once a certain level of profitability is achieved, a maximum consideration is paid. This was one of the downfalls of listed peer Photon Group. Some of it's earn outs were not capped, therefore the liability escalated when one particular business significantly outperformed.

We rated the company and identified a catalyst that would change the valuation, so we commenced purchasing the shares in September 2009 for WAM Capital. The stock continued to "rate" in our ratings template with >10% earnings growth forecast for the year to 31 December 2010 and a price to earnings ratio of 8x.

Another catalyst for purchase during late 2010 was a major shareholder liquidating their investment in STW. This put significant pressure on the share price for that period as the weight of selling in the market each day suppressed the share price. Once the stock cleared the share price moved quickly over \$1.00 after trading in the \$0.80 range for 1-2 months. This type of activity is common when large lines of stock are seen as an "overhang" on the share price. Once the selling clears, the share price quickly re rates as the selling comes to an end.

We continue to like the STW story with the share price at the time of writing trading at \$1.33. The focus on organic growth rather than growth by acquisition is a positive. For the 2011 financial year we forecast >10% EPS growth. This year the company's earn out liabilities peak. Post this event debt will significantly reduce as higher levels of free cash flow are applied to debt reduction. An increase in payout ratio up from 40-50% back towards historical levels of 70-80% is a possibility. Currently at 40-50%, we see scope for it to increase back towards historical levels of 70-80%.

## *A closer look at our holdings*

### RP Data (Market Driven)

RP Data Ltd (RPX) is a provider of property information in Australia and New Zealand.



RP Data Ltd (RPX) is a provider of property information in Australia and New Zealand and is a company we know well and have invested in the past. On the 12th January 2011 while scanning through the daily ASX announcements before the market opened we discovered that RP Data Limited (RPX) had made an announcement recommending a takeover proposal by its largest shareholder CoreLogic.

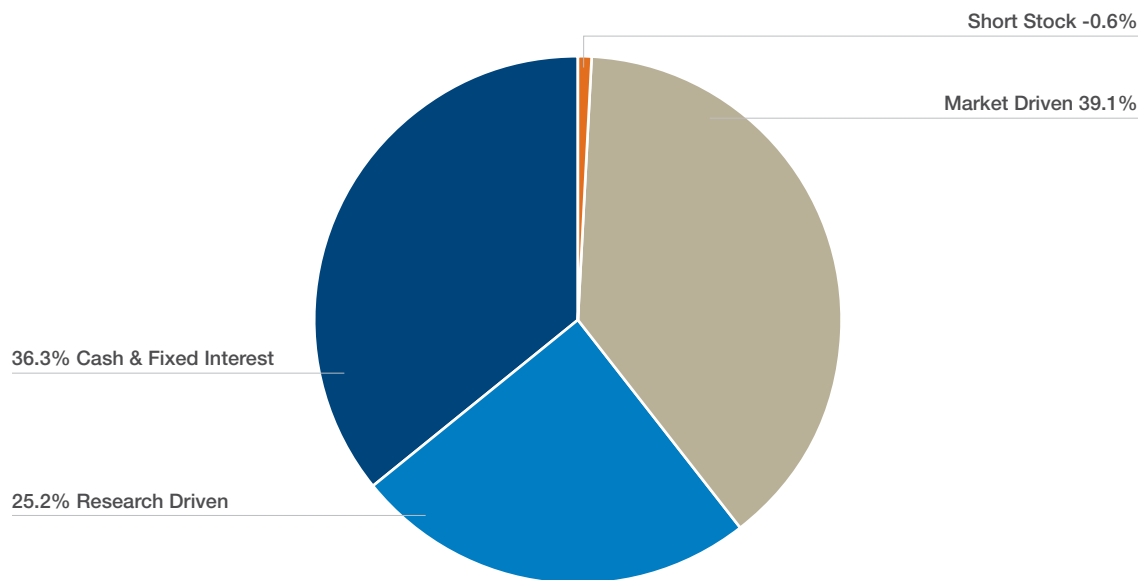
Over the next 15 minutes we read through all the details and conditions of the takeover proposal to identify any major obstacles to the successful implementation of the takeover. We were quickly able to deduce that there were only minimal conditions and there was a high probability of the takeover succeeding as the bidding company already held 39% of the shares on issue. The offer also had been recommended by the RP Data board. The takeover was \$1.64 per share together with a \$0.05 fully franked special dividend bringing the total proceeds to \$1.70. We then calculated the annualised return.

The stock resumed trading at \$1.62. This price would deliver an annualised return of 14.4%. This represented a higher return when compared to the interest on our cash holding which is currently 6.0%. We invested 0.6% of the portfolio into the company at \$1.62 within the first half an hour of the stock opening for trade. The stock closed the day at \$1.64 and was trading at \$1.65 two days later.

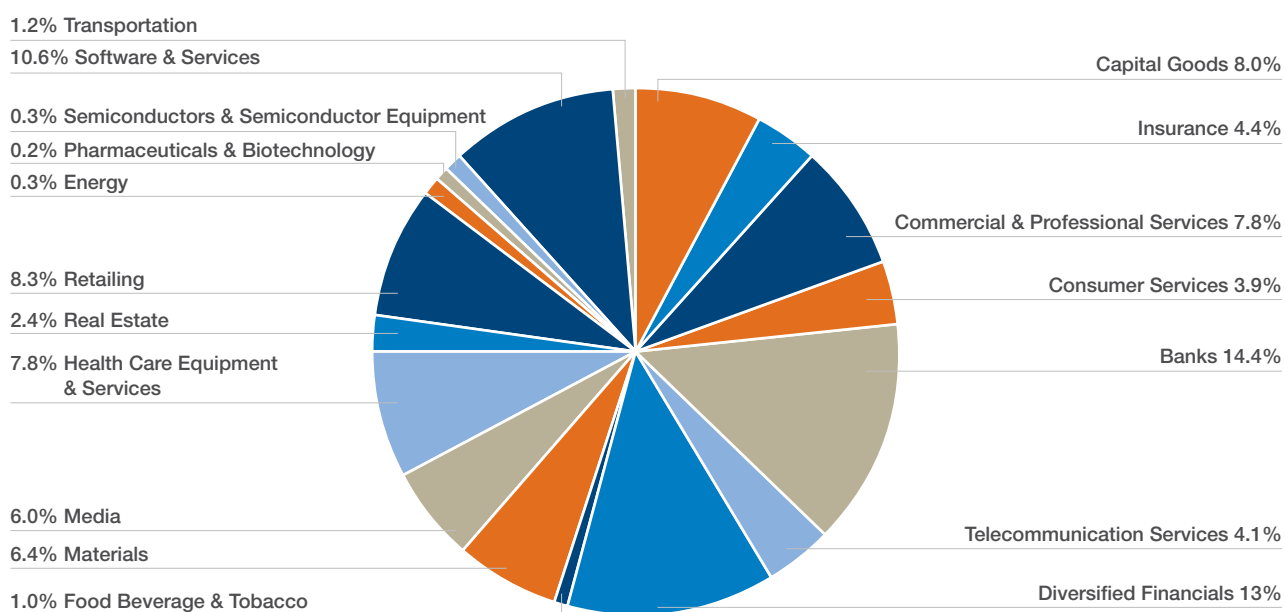
Our quick decision making, fast-response and open plan office which promotes open communication allowed us to rapidly identify and execute the trade. These types of trades are common in the market driven portion of WAM Capital. When we identify an opportunity such as this where we see minimal risk and return above cash, we invest.

# Portfolio Summary as at 31 December 2010

## Portfolio Asset Allocation



## Portfolio Sector Allocation



## Top 10 Research Driven Stocks as at 31 December 2010

ASX Code	Company Name	Sector	Market Value \$m	% of Gross Assets
RKN	Reckon Limited	Software & Services	8.8	4.8%
MMS	McMillan Shakespeare Limited	Commercial & Professional Services	5.3	2.9%
MYS	Mystate Limited	Banks	3.1	1.7%
SGN	STW Communications Group Limited	Media	3.0	1.6%
TGA	Thorn Group Limited	Retailing	2.4	1.3%
SAI	SAI Global Limited	Commercial & Professional Services	2.1	1.2%
MAQ	Macquarie Telecom Group Limited	Telecommunication Services	2.0	1.1%
BRG	Breville Group Limited	Retailing	1.9	1.1%
BKL	Blackmores Limited	Health Care Equipment & Services	1.9	1.1%
IRE	IRESS Market Technology Limited	Software & Services	1.9	1.0%

## Top 10 Market Driven Stocks as at 31 December 2010

ASX Code	Company Name	Sector	Market Value \$m	% of Gross Assets
RHG	RHG Limited	Banks	5.3	2.9%
TAL	Tower Australia Group Limited	Insurance	5.1	2.8%
PRY	Primary Health Care Limited	Health Care Equipment & Services	3.9	2.1%
CSR	CSR Limited	Capital Goods	3.4	1.9%
JHX	James Hardie Industries Se	Materials	3.4	1.9%
FLT	Flight Centre Limited	Consumer Services	2.7	1.5%
SGI	Signature Capital Investments Limited	Diversified Financials	2.4	1.3%
PRV	Premium Investors Limited	Diversified Financials	2.3	1.3%
CBA	Commonwealth Bank of Australia	Banks	1.8	1.0%
ELI	Emerging Leaders Investments Limited	Diversified Financials	1.7	1.0%

## Best Performing Stocks to 31 December 2010

ASX Code	Company Name	Sector	Unrealised/ Realised Gains
MMS	McMillan Shakespeare Limited	Commercial & Professional Services	\$3,672,290
RHG	RHG Limited	Banks	\$1,884,968
TAL	Tower Australia Group Limited	Insurance	\$1,823,699
RKN	Reckon Limited	Software & Services	\$1,283,002
MAQ	Macquarie Telecom Group Limited	Telecommunication Services	\$1,225,759

## Worst Performing Stocks to 31 December 2010

ASX Code	Company Name	Sector	Unrealised/ Realised Losses
TSM	Thinksmart Limited	Diversified Financials	(\$375,988)
AKF	Ask Funding Limited	Diversified Financials	(\$265,562)
EFG	Everest Financial Group Limited	Diversified Financials	(\$242,946)
MQG	Macquarie Group Limited	Diversified Financials	(\$188,540)
DJS	David Jones Limited	Retailing	(\$181,878)

# Director Profile – Introducing James Chirnside

James has been a Director of WAM Capital since February 2003.



James began his career in financial markets in 1985 as a derivatives broker for Bell Commodities in Melbourne, then Sydney, and London. He joined County Natwest London in 1989 where he managed a proprietary trading book, investing in Japanese equities. In 1993 James moved to emerging markets specialist Regent Fund Management and was based in Hong Kong.

At RFM he was responsible for investment activities in private and public equity and debt across Asia including Japan, Australia, Eastern Europe and Russia.

James setup and managed the first – and at the time, the largest (US\$350 million) – Asian Equity Hedge Fund. In 1994 the fund was awarded first place in the Global Hedge Fund performance table by S&P Micropal.

In 1999 he joined Challenger International in Sydney where he developed an Alternative Investments business for the company. In August 2002 he established Asia Pacific Asset Management. APAM is an independent, specialist, emerging markets investment company.

## **Under the microscope:**

**James' view on Inflation, Commodities, and Stocks**

In 1981 US Treasury Bond yields peaked at around 15.0%. From that time we have seen developed economy interest rates falling as the Oil Shock induced inflation period was finally beaten. Paul Volker was running the US Federal Reserve at that time and remains to this day probably the most respected monetary official in US history. Low volatility accompanied falling inflation and interest rates. Equity markets flourished. This investment sweet spot lasted until November 2006 when the US subprime disaster began to unfold leading to the Global Financial Crisis.

A number of other developments have since conspired to create a new age of global inflationary pressure. It is not clear-cut. In developed economies we have debt-induced deflation with falling house prices and rising unemployment. In emerging economies there are significant inflationary pressures mainly through wages growth and commodity price rises. This is creating civil unrest as we have seen.

What does this mean for stocks?

We believe that Commodity stocks will continue to benefit in this environment, as will industrial stocks that retain pricing power, such as infrastructure and engineering issues. In our view the asset class that remains most vulnerable continues to be government debt.

## New-look website

We are pleased to announce that this month we have launched our new and improved website.

Our goal was to provide our clients with an interactive, user-friendly experience. While we offer the same useful information, you will notice some new sections:

- Newsroom – this will include latest newspaper articles on both our funds and the industry, audiocasts by our investment team
- A biography on each of our team members
- Section for Financial Advisors – this will include latest independent research on our funds.

We will continually strive to add more information to update you with the latest news.



[www.wamfunds.com.au](http://www.wamfunds.com.au)

## WIN A LUNCH with Geoff Wilson!

We would like to encourage all shareholders to visit our new website, and let us know what you think – good or bad!

Visit the Feedback section on our website, and complete the online form by 31 March 2011. The shareholders that provide the most constructive feedback (as voted by our investment team) will each receive a copy of one of these leading financial books. In addition, one of these lucky shareholders will also win the opportunity to have an enjoyable lunch with Geoff Wilson who will discuss his view of the market and some of the stocks held in the portfolio.



**20 BOOKS TO GIVE AWAY!**



**WILSON**  
ASSET MANAGEMENT

Wilson Asset Management is an independently owned boutique investment manager established in 1997 by Geoff Wilson. Wilson Asset Management is based in Sydney, Australia.

The Wilson Asset Management Group (WAM Group) is comprised of five investment professionals who have a total investment experience of over 50 years.

The WAM Group is the manager of three listed investment companies with funds under management of approximately \$314 million. The group also manages unlisted funds of approximately \$25 million.

In August 1999 the first of the three listed companies, WAM Capital Limited (WAM), was established and has grown from \$21.5 million to approximately \$187 million today. WAM predominantly invests in small to medium sized companies listed on the ASX for the short to medium term.

In August 2003 the second listed investment company, WAM Research Limited (WAX) (previously known as Wilson Investment Fund Limited), was established with \$161 million raised and currently \$108 million. WAX predominantly invests in small to medium sized industrial companies listed on the ASX for the medium to long term.

WAM Active Limited (WAA) is the most recent addition to the group which was listed in January 2008 with approximately \$15 million raised and currently \$19 million. WAA is an active investor with high turnover and a focus on absolute returns.

## CONTACT US

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