THE INTELLIGENT INVESTOR
VALUE INVESTING EXPERTS
SPECIAL REPORT

Top stocks for 3 years

Dear reader,

'Life is like a box of chocolates,' said Forrest Gump's mother, 'you never know what you're going to get.' And that would seem to sum up our inaugural 'top three stocks for three years' contest (see page 11 for the final wrap-up).

Despite losing Croesus Mining early, our stocks got off to a sprightly start, with an average return of 23% at the one-year mark. By the end of year two, the average return had pushed out to 59% and, with Tim Searles and Tony Scenna having doubled their money, it looked like an exceptional performance would be required to take first place. But it all came crashing down in year three, to leave us back where we started—or just below—with an average loss of 4%. In the end, a gain of 29% from yours truly was enough to claim the laurels.

Still, with the All Ordinaries Accumulation Index dropping 8% over the period, we didn't do too badly in relative terms. And it's been a lot of fun (an absolute hoot for me at the end there, I have to say), so we've decided to do it all again.

When the selections were made for the original contest, our analysts were generally feeling nervous about valuations, which caused us to spread a wide net in search of value. But that approach came back to bite many as the bear market surprised even us with its severity; it hasn't been a time to stray too far from the beaten track.

Perhaps burnt by that experience, there's a much higher proportion of blue chips selected this time around. **Flight Centre**—perhaps the hub of the first contest's rollercoaster ride—has proved the most popular pick again, with an astonishing seven out of eight analysts picking the stock.

If you're a good contrarian, this overwhelming endorsement might make you run a mile. That's one way of looking at it. The other is that it's a stock our analysts understand as well as any other and we have a strong conviction that it's currently a screaming bargain. It'll be interesting to see how it turns out.

Without wanting to put words into his mouth—or stocks in his portfolio—it's a reasonable bet that Flight Centre will get another backer when Gareth Brown is able to file his submission. Unfortunately (very), he was recently waylaid somewhere in the environs of Bangkok airport and, while he's now made it home, he's managed to pick up a nasty bug along the way. We'll let him join the competition when he's ready to do some thinking and, as compensation for the illness and to keep life simple, we might even let him join at the same prices as the rest of us. Knowing Gareth, a few cents here and there on his favourite stocks is unlikely to make a lot of difference.

Of course, with such concentrated portfolios for such a short period of time, our 'contest' isn't actually much use as a contest. But it does provide a window on the thinking of our analysts—and of course it gives you their top current selections. We hope you enjoy it.

Wishing you a merry Christmas and a prosperous new year,

James Carlisle
Editor

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James Greenhalgh

In making his selections, James was looking for stocks that can go the distance—and as if to emphasise the point two of them are the same as last time.

Unlike some of my colleagues, I don't believe the events of 2008 are apocalyptic. Rather, I believe they have created some of the best buying opportunities around. With that in mind, it wasn't as hard to find bargains this time as it was for the first series of 'Top Stocks for Three Years'.

I also learned two things from the earlier series. One, dividends can make a big difference to your returns. Two, and particularly salient for a competition like this, is that you must select companies that can go the distance. Small or highly indebted companies are risky, so they don't belong in a competition where you can't sell in my view. Buffett has suggested that you should only buy companies you'd be happy to hold if the stockmarket shut for 10 years. With this competition it effectively does shut for three.

All the companies I've selected are blue chip market leaders. Only one of them has any debt, and even it's relatively lowly geared. Each one has an owner-manager in charge, and each one is deeply out of favour and down at least 60% from its 2007 highs. Finally, please accept my apologies if you were hoping for new ideas—two of my picks are the same as the first series, and the third one probably won't come as much of a surprise.

Flight Centre

My first pick is Flight Centre. Despite apparent maturity in Australia, it still looks like the classic growth company to me, with potential to expand in areas such as corporate travel. And I like the fact that its competitors, such as Stella and Jetset, have been having problems this year. Inevitably, these issues tend to make the market leader stronger. The company also has a strong culture and an incentive system in place that rewards staff performance.

Flight Centre is also one of relatively few Australian companies to have made a decent go of overseas expansion (which now generates 42% of total transaction revenue). While its international businesses typically take a while to get established, Flight Centre sticks with them—one of the hallmarks of long-term thinking.

Consistent with its past, integration and restructuring costs mean recent acquisition Liberty is underperforming. Combine that with a likely fall in profit in 2009 as the Australian and global recessions start to bite, and the stock is out of favour.

The market seems to be pricing in at least a 50% fall in profit given the current historical PER of 6.6. Perhaps that will occur over the next year or two, but it's a big call. And, by late 2011, a recovery should be well underway. To me, Flight Centre looks like one of the cheapest blue chips around.

Harvey Norman

My second pick is Harvey Norman. I know retail is a tough business, but this is no ordinary retailer. For one thing, apart from its new OFIS office supplies chain, which I'm somewhat sceptical about, the company isn't strictly even a retailer in Australia. Rather, the company is a franchisor and property owner, which means it derives income and rent from its network of Harvey Norman retailer franchisees in Australia.

All sales-oriented businesses—including Harvey Norman and Flight Centre—need to have the right incentives in place. As franchisees own their businesses, they tend to work harder, which means the company does well when they do well. But the company is also like a protective big brother, providing support to franchisees in tough times.

Few retailers own much property, but Harvey Norman owns $1.7bn worth. This not only gives it more stability than your average retailer, but provides flexibility for future development and expansion. And the company can easily support its current net debt of a little over $500m as at 30 June 2008, although it will need to refinance $221m of mortgage-backed securities by May 2009.

The other thing I like is Gerry Harvey's opportunism. After acquiring Retravision NSW and Megamart cheaply, he then sold Rebel Sport to private equity interests at what now looks like the peak of the retail cycle in 2007. I'm betting the company will pick up a few distressed retail assets during this downturn.

Sure, the recession will hit profits in 2009, perhaps severely. And the company's expansion into Ireland looks like it might have been a mistake. But I think the company's market strength, business model and exposure to the growing electronic products market is a powerful combination—particularly at this price.

Platinum Asset Management

My final pick is Platinum Asset Management. As with my other selections, profit will certainly fall in 2009. But the lifeblood of any fund manager—unless they bribe financial advisers with commissions—is investment performance. Platinum Asset Management has it in spades, with a long-term reputation managing international equities that is second to none in Australia.

James's Gems

STOCK (ASX CODE)	PRICE AT 10/12/08	MOST RECENT REVIEW
Flight Centre (FLT)	$9.64	12 Nov 08 (Buy—$10.86)
Harvey Norman (HVN)	$2.30	26 Nov 08 (Buy—$2.20)
Platinum Asset Management (PTM)	$3.44	25 Nov 08 (Buy—$3.40)

While the absolute performance of international stocks has been poor for a few years now, Platinum has done very well relative to most markets and most competitors. And, thanks to its shorting and currency management programs, it has extended this lead over the past six months. This positions the company to attract significant fund inflows when market sentiment turns.

Also, after being averse to marketing for some time,

Platinum has announced it will hire some marketing staff. It also intends to seek out new institutional mandates, and I'm optimistic it can pick some up given recent strong performance.

Like Flight Centre, Platinum has no debt and pumps out loads of cash. My main concern is that the company might fail to capitalise on recovering markets. And, with the International Fund—managed by owner-manager Kerr Neilson—producing the biggest outperformance of any of the company's funds over the past six months, it remains somewhat dependent on his investment nous. By 2011, Neilson will be 62.

I'm confident Platinum will have grown its funds under management significantly by that date through both investment performance and fund inflows. A 40% increase by then—quite attainable in my view—would be enough to justify a share price of close to double its current levels.

Disclosure: James owns shares in Flight Centre, Harvey Norman and Platinum Asset Management, as do other staff members.

Tim Searles

With first-hand experience of Servcorp and some snooping around JB Hi-Fis, Tim's been getting close and personal to his selections. All he needs now is to book a holiday through Flight Centre.

Sorry to be boring but I'm sticking with two of my previous picks, Flight Centre and JB Hi-Fi. I like them both and they served me well last time, though recent share price falls brought my performance back to earth. I'm not complaining, though—I wouldn't be picking them this time around if it wasn't for lower prices.

Hopefully it won't be too hard to beat the performance of my third stock, Croesus Mining. Paradoxically, the gold miner came unstuck because of the rising gold price. I was originally going for a conservative option after the shame and burden of picking a bankrupt last time, but changed my mind at the last minute. Rather than safer choices such as **Corporate Express** and **Cabcharge**, I've opted for a favourite of mine, Servcorp.

My concern in picking Servcorp is that all three selections are dependent on economic conditions. With each having significant operating leverage, a long recession—which is possible—would hurt in the short term. However, I think they are quality businesses which should be well placed to deal with a downturn and even take advantage of any opportunities.

JB Hi-Fi

JB has certainly done it for me again. Its record since listing in late 2003 has been incredible. The combination of new stores and higher sales at existing stores saw the company increase its net profit from $13.8m in 2004 to $65.1m in 2008.

In the four years to 2008, the company went from 32 stores to 105, including an expansion into New Zealand and the acquisition of Clive Anthony. Such rapid expansion is not normally a good thing, but JB is a better business on just about every measure. For example, its profit margin increased from 5.0% to 5.6% over the four years, despite a fall in its gross margin from 23.4% to 21.9%. In other words, it increased profits despite lower prices. JB achieved this by reducing its cost of doing business (operating costs as a percentage of sales) from 17.8% to 15.3%.

Of course, the retail conditions over the past four years have been a huge tailwind. Demand for its electronics products has been unprecedented, which has combined nicely with falling prices, easy credit and higher incomes. However, the company has soundly beaten its competitors such as **Harvey Norman**, **Woolworths** (Dick Smith Electronics) and **Clive Peeters**. It's not all about opening new stores either. JB has managed to report like-for-like sales growth in every period, including a massive 15.3% increase in 2008.

While conditions are tougher for retailers at the moment, JB has held up well so far. Not only is the company helped by being a discounter, it sells a range of products rather than just expensive ones such as plasma televisions. Unlike many competitors, JB keeps its sales ticking over with low priced—and popular—products such as games, CDs and DVDs.

My main concern is debt. At the end of June, JB had net debt-to-equity of 76%. A better measure for retailers is interest cover and that was 12 times for 2008. Compared with most companies that's quite good, but retailers should have low debt as they have large rent obligations.

As recently as late October the company was 'confident' of achieving its 2009 sales forecast of $2.3bn. This would equate to earnings before interest and tax of $92m if we assume its profit margin falls to 4%. That puts JB on a PER of 16.6 if we assume it pays $35m in interest and tax. It's a fair price, in my opinion, considering JB's quality and growth potential. A recent walk through a couple of stores gave me confidence despite the doom and gloom you see in the media—customers were still lining up at its cash registers.

Flight Centre

There's probably not much for me to add to Gareth's reviews on Flight Centre. I too like the company. It has a long track record of increasing profits, is very well managed, is available for a good price and is conservatively financed.

Its shares look cheap because tough times and lower profits are expected. Indeed, the company has recently announced a profit downgrade. That's to be expected with headwinds such as an economic downturn, indebted consumers and a lower Australian dollar.

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Tim Searles

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Demand is down for Flight Centre's traditional earner, long-haul international flights, but it has many other strings to its bow. The company has been expanding its corporate business and also sells various other travel products such as cruises and hotel bookings. People will still go on holiday, even if only to Cairns or New Zealand.

One of the things I like best about Flight Centre is its economics. Like most retailers, it gets paid in advance so has good cash flows. However, it doesn't stock inventory, a typical retailer's main drawback. Having good economics has helped the company expand without the need for new capital and still pay most of its earnings as dividends. There are not many companies that can do this.

This advantage can present problems, though. Management must be disciplined in using its cash flow productively. In the past this has been the case as chief executive Graham Turner is sensible and conservative.

Servcorp

As an occasional customer of Servcorp, I can vouch for the fact that its products and customer service are first class. I've also tried a competitor but there was no comparison. With a quality business, conservative management with a large investment in the company and attractive financials, Servcorp's positives outweighed my concerns about overly exposing my portfolio to economic conditions.

As with JB and Flight Centre, in the long run an economic downturn will be good for Servcorp. Whilst profits will be lower as businesses cut back spending, the company will come out the other side in a better position.

That's what happened in the last slowdown in 2002. Many of its competitors went bankrupt and the company was able to use its strong financial position to expand into new areas. With a recently announced expansion into the troubled leasing market of London, it's already taking advantage of opportunities.

Tim's Top Tips

STOCK (ASX CODE)	PRICE AT 10/12/08	MOST RECENT REVIEW
JB Hi-Fi (JBH)	$8.95	20 Aug 08 (Hold—$12.59)
Flight Centre (FLT)	$9.64	12 Nov 08 (Buy—$10.86)
Servcorp (SRV)	$2.97	14 Nov 08 (Buy—$3.00)

Having about 80 cents per share in net cash and trading on a PER of 7.1 times its 2008 earnings per share of 42 cents, the company offers good value. Profits may well go lower with the economy, but I expect Servcorp to do well over the long term.

Disclosure: Tim owns shares in Flight Centre and Servcorp, as do other staff members.

Alex Chin

Alex, our youngest analyst, is in good company with Flight Centre, but he's gone off on a limb with his other two choices.

In cautious times, it's often said that cash is king. In my hunt for three top stocks, I wanted companies with cash in the bank that the market had overlooked, or which were making buckets of it and trading at low prices. It's a great time to be on the hunt for value, with a number of high-quality companies trading at good prices.

Flight Centre

My first pick is Flight Centre. I watched it hit $9 three years ago and kicked myself for not pulling the trigger. Now is a great time to pick some up at similar prices. The company ticks the right boxes: it dominates its sector, has first-class management and the business is much stronger now than it was three years ago.

The biggest concern I have over the short term is the slowdown in travel. The combination of less spending power and a much weaker Australian dollar has put a dent in people's travel plans. Competitor Jetset Travelworld, for example, recently announced that next year's profit would be 20% to 30% lower than its forecast. But I think Flight Centre's product mix, from students to corporate customers, is the best positioned in the industry to withstand the turbulence.

It helps, of course, that the company has plenty of cash and produces significant free cash flow. The question is what management intends to do with the money. My preference would be for them to start buying back stock, but they'll probably look to acquire competitors cheaply while they're feeling the pinch. Regardless of the approach taken, though, shareholders should be the winners.

I've put my money where my mouth is and recently bought shares around current prices. At 7.8 times the average free cash flow for the last 10 years, Flight Centre is an easy decision.

IMF (Australia)

Second on my list is litigation funder IMF (Australia). Contrary to popular perception, it isn't a law firm; it funds court actions and takes a cut, typically 30%, of any monetary award if the case is settled successfully.

As a result, earnings will be lumpy. But when the business is firing on all cylinders, earnings can go through the roof. In the record 2008 year, IMF made a profit of $33.5m on court cases on which it had invested $21.7m. That's an enviable 154% return. Though it should be pointed out the average age of these cases (from

start of case to settlement) was 5 years, which gives a compound annual return of 20.5%.

But the more obvious value in IMF is in its huge pile of net cash. Compared to its market capitalisation of $91m, there's $83.5m in the bank, which implies that the rest of the business is worth $8.5m. Of course many, if not most, of its cases won't make a return, but those that do could potentially produce many multiples of $8.5m.

And some of the cash should soon be winging its way to shareholders, with management recently saying that only $50m was needed to run the business. Of the $33.5m in excess cash, $11.4m will be given to shareholders as a return of capital, assuming the tax office gives it the green light. The rest is likely to be returned at some point as well, perhaps as a special dividend.

IMF is like an asset play, except that you're getting an almost free option in a strong business. Going into a downturn, one thing you can be sure about is that people will take each other to court—as we're seeing already with Centro and A.B.C. Learning shareholders going to court to recoup lost money.

Noni B

My third selection is womenswear retailer Noni B. I chose it because the business is in the doldrums and, if the retail cycle picks up, women's fashion should be one of the first areas to benefit as wardrobes get overhauled to keep up with the latest trends.

There's plenty of uncertainty on when the retail cycle will rebound, though. Noni B's management has retracted its 2009 earnings forecast, saying the situation was dire in the lead-up to Christmas. Importantly, there was no prediction on what would happen in the new year, suggesting things could get worse. In fact, I wouldn't be surprised if 2009 pre-tax earnings (adjusted for restructuring costs) halved to $2.5m.

Chin's Choices

STOCK (ASX CODE)	PRICE AT 10/12/08	MOST RECENT REVIEW
Flight Centre (FLT)	$9.64	12 Nov 08 (Buy—$10.86)
IMF (Australia) (IMF)	$0.76	N/A
Noni B (NBL)	$1.03	N/A

Essentially I'm betting on a retail turnaround over the next three years. I deliberately didn't choose Harvey Norman (it came very close, mind you) because we may be seeing the end of 'big-ticket' purchases for a long time, and the profit margins on these items are wafer-thin. With Noni B, you're getting owner-managers running the show and a strong fashion label very cheaply.

Disclosure: Alex owns shares in Flight Centre and IMF (Australia). Other staff members own shares in Flight Centre.

Greg Hoffman

Undeterred by picking wipeout Croesus Mining last time around, our research director has gone for a commodity producer again—but this one has a large pile of cash.

I found this year's selections extremely difficult. With the market's savage falls, part of me felt that selecting three stocks that will shoot the lights out should be easy. But, when it came to it, I found it quite difficult—especially after my atrocious results in our previous competition.

It's impossible to build a well balanced portfolio with only three stocks, so I was torn between selecting stocks that I believe offer deep value but come with a hefty dose of risk (as I did last time), or opting for three safer options that would almost certainly preclude a very bad result, but also a very good one.

In the end, I've opted for the value—but the selections should be seen in context. I'm clearly not suggesting that anyone should put a third of their portfolio into any of my three picks, and particularly not a mid-sized oil company.

Flight Centre

It was a toss-up between **Platinum Asset Management** and Flight Centre for my first pick. With regard to Platinum, I like its conservative balance sheet with no debt and tens of millions in cash. I also think its profitability is likely to explode once the current turmoil ends and investors are attracted by its funds' outperformance through this difficult period. But a degree of this is already factored in to the current stock price. That's why I've opted for the more cheaply priced Flight Centre, which I've recently added to my super fund.

The current economic downturn and sharply lower Australian dollar won't be doing it any favours, but today's price is compensating for a lot of bad news. I'm sure some of the other Flight Centre bulls in the office will have made the case in more detail in their selections, so I'll say less rather than more and move on.

Infomedia

I considered a number of second-line stocks for my next selection. It's an area of the market where I feel there are currently a lot of opportunities. These include **Corporate Express**, **Mortgage Choice**, **STW Communications** and **Servcorp**. In the end, I've gone for a stock that many have given up on: Infomedia. We've followed it for almost five years now and I feel that our team knows it as well as anyone in the investment community (so we're less likely to be blindsided by bad business surprises).

The current dire financial straits of many car dealers (as distinct from car manufacturers) is a concern, though. If car dealers go out of business in droves, then demand for Infomedia's products will be hit. But this company has a conservative balance sheet with net cash and is a beneficiary of the sharply lower Australian dollar (albeit on a deferred basis due to its currency hedging program).

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Greg Hoffman

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Infomedia is cheaply priced and has also been buying back stock, which should pay off nicely in a few years' time. I'm reminded of our change back to a positive call on the then Miller's Retail (now **Specialty Fashion Group**) on *25 May 2005 (Speculative Buy—$0.685)* after a torrid ride down. It rose by 148% over the following nine months and we were able to sell out for $1.70 per share. I started that review with the following quote from *Value Investing: From Graham to Buffett and Beyond* by Greenwald, Kahn, Sonkin and van Biema, and I believe it's applicable here:

Hoffman's Heroes

STOCK (ASX CODE)	PRICE AT 10/12/08	MOST RECENT REVIEW
Flight Centre (FLT)	$9.64	12 Nov 08 (Buy—$10.86)
Infomedia (IFM)	$0.295	10 Dec 08 (Buy—$0.295)
Australian Worldwide Exploration (AWE)	$2.39	10 Oct 08 (Speculative Buy—$1.93)

'We dislike risk and hate losing money. There's nothing wrong with that, except that we confuse past fiascos with future disappointments. Stocks that have declined in price are tainted, even though the lower price at which we can buy them covers a multitude of old sins. So we let our analysis be colored by an emotional taint that hinders our efforts at producing an unbiased picture of a company's prospects and a security's value. We love winners more than we should, and we avoid losers so that we don't notice when situations improve and yesterday's failure is tomorrow's comeback of the year.'

Australian Worldwide Exploration

For my final pick, I considered adding **Westfield** or an income security, which would have been the conservative option. Instead, I've gone right to the other end of the spectrum and gone for Australian Worldwide Exploration (AWE), which is another stock I've recently added to my super fund. After a horrendous result with Croesus Mining last time, I certainly thought twice before including a single-commodity producer. Last time around I got the commodity right (the Australian dollar gold price has almost doubled over the past three years) but came unstuck with the company producing it.

Gareth Brown and I laid out the case for AWE on *10 Oct 08 (Speculative Buy—$1.93)* and, while the oil price is noticeably lower and AWE's share price is up somewhat since then, I'm counting on the company's conservative balance sheet and established reserve base pulling it through. For the record, I'm also a long-term bull on the oil price, particularly from these levels.

Disclosure: Greg owns shares in Flight Centre, Infomedia and Australian Worldwide Exploration. Other staff members own shares in Flight Centre and Infomedia.

Nathan Bell

The pursuit of knowledge is a wonderful thing, but Nathan is taking it to new extremes.

Ordinarily I own around half a dozen stocks. I believe genuine bargains are scarce, you need to keep your opportunity cost as high as possible and it's better to know a few stocks well than to spread your cash and time too thin.

The result is a mixture of familiar names, including **Cochlear** and **Macquarie Group**, and some house favourites, such as **Platinum Asset Management**, **STW Communications**, **Infomedia** and **Flight Centre**.

Despite some obvious differences, they share common attractions. Management usually has a significant stake or, at least, a decent track record, and the businesses should be able to compound returns at a rate of knots when conditions are favourable.

Knowledge companies

They are also what Michael J. Mauboussin refers to as 'knowledge companies' (see his excellent book *More than you know: Finding financial wisdom in unconventional places*). That is, they enjoy benefits of scale, as opposed to 'physical companies', for example, which need to spend more money to make more money.

Successful knowledge companies enjoy high profit margins and return on equity and prodigious free cash flow. And—casting Macquarie Group and STW aside—because they largely fund themselves from operating cash flow, debt levels are low. Management can therefore focus on making good business decisions, even during a financial crisis.

Selecting three stocks from a short list should be easy, but large and high-quality companies have fallen to levels not seen in five years and valuations at the smaller end of the market look downright cheap, despite the additional risks—STW Communications, for example.

So which is it to be, higher quality or a larger discount? Two other stocks on my radar are **Harvey Norman** and **Westfield**, but I believe Infomedia and STW Communications are potentially the cheapest. Nonetheless, I've picked three stocks I'd feel comfortable recommending to my family.

Cochlear

Cochlear is the world's leading hearing implant manufacturer and by far and away the most expensive stock on my radar, relatively speaking. Because profits are inextricably tied to national healthcare budgets rather than the general economy, Cochlear's safe-harbour status has been supporting its share price.

Its share of the global hearing implant market is roughly 70% and its enviable list of high-margin products keeps

growing. The Baha acquisition is exceeding expectations and management has suggested that some of its technology is 10 years ahead of competitors.

Buying Cochlear on an earnings multiple in the twenties has its risks, though. Competitors are no doubt trying hard to bridge the gap and they could potentially introduce superior technology at more affordable prices. Deafness research continues outside the corporate sector and a cure would most likely spell doom for Cochlear.

Until that happens, though, (and even shareholders no doubt would wish it sooner rather than later) Cochlear's 'hear now and always' policy, where new technology benefits past implant recipients without invasive surgery, is a formidable barrier to competition. With an additional fillip from the lower Aussie dollar, the future should be very profitable.

The current price might not look like a bargain, but with Cochlear's markets expanding faster than supply, its superior technology and a chief executive focused on shareholder returns, this is a stock out of the very top drawer.

Platinum Asset Management

There are several attractions to Platinum Asset Management. First, I like the culture. Founder Kerr Nielson is sharp, frugal and has three decades of experience in financial markets. He knows the difference between price and value and, with most of his personal fortune on the line, I expect that by surrounding himself with like-minded investors he is preparing Platinum to withstand many bear markets to come.

Bell's Beauties

STOCK (ASX CODE)	PRICE AT 10/12/08	MOST RECENT REVIEW
Cochlear (COH)	$56.49	13 Aug 08 (Long Term Buy—$51.52)
Platinum Asset Management (PTM)	$3.44	25 Nov 08 (Buy—$3.40)
Flight Centre (FLT)	$9.64	12 Nov 08 (Buy—$10.86)

Then there's the quality of the business itself. The operating margins are incredible. Unlike BHP, which has to pay $25,000 for new truck tyres, Platinum's only major expense is its investment analysts who are worked hard—just the way I like it. Base salaries are relatively low by industry standards but performance bonuses are lucrative—as long as they're earned I'm happy to pay them. And Platinum produces so much cash that debt needn't appear on the balance sheet—and it doesn't.

As always there are risks. Falling markets and fund withdrawals are a toxic combination, but I like companies whose destinies are in their own hands. Platinum's stock will eventually rise if its investment performance stacks up and I'm comfortable Neilson and his team will capitalise on the current turmoil.

It might be a rocky ride, but when Charlie Munger acknowledges that funds management businesses are amongst the best you can own, I listen.

Flight Centre

No doubt the biggest financial mistake of my life to date was not selling all my Flight Centre shares at $32. And it can often be a mistake to return to stocks that have worked out well in the past but have deteriorated in the interim—it's easy to let your emotions cloud your judgement. But being forewarned is being forearmed, and after considering these risks, the stock still looks extremely cheap.

Flight Centre depends on discretionary spending and, despite management suggesting a lower Aussie dollar means people will travel within Australia rather than cancel vacations altogether, I expect rising unemployment will significantly dampen profits for at least a year or two—I've already scuttled my family's holiday plans. But this is a temporary issue and, longer term, Flight Centre needs to keep battling competing internet sites, which offer customers more choices.

Flight Centre's strength is a culture that rewards high-performing staff and who will no doubt be working overtime in the current environment. It's reminiscent of Berkshire Hathaway where managers run their businesses independently with stunning results.

If the Liberty acquisition pays off, Flight Centre could be worth multiples of its current price and, if not, a cash-laden balance sheet should ensure its survival. It might take several years for profits to thrive again but, at today's price, we're expecting to do very well when they do.

I decided against picking what I think are the outright cheapest stocks. In preference I've selected three conservatively financed companies run by shrewd management, which I expect to emerge from the downturn in a more competitive position and capable of earning higher profits. No doubt Mr Market will still find a way of humiliating me in the years ahead, but that's all part of the fun of investing. Merry Xmas.

Disclosure: Nathan owns shares in Cochlear, Platinum Asset Management and Flight Centre, as do other staff members.

Steve Johnson

Our managing director is anticipating extremely difficult times for the Australian economy and he's made his selections accordingly.

I was asked just last week what was the biggest lesson I'd learned from of the stockmarket rout of 2008. The answer is that I should have taken more notice of the advice I heard straight from Warren Buffett's mouth at the 2006 Berkshire Hathaway AGM: 'It's hard to pay a low enough multiple for a business in decline.'

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Steve Johnson [CONTINUED FROM PAGE 7]

Despite taking this advice to heart and being vocal in my negative opinions about 'old media' stocks and the impact of too much leverage on Australia's consumers, I've still placed too much emphasis on the financial analysis and not enough on the potential impact of changes in the business environment.

We've anticipated most of the risks and perhaps knocked 10% or 20% off a valuation to compensate for a declining industry, a poor outlook or a balance sheet with too much debt. But when those risks come home to roost, we've seen the earning capacity of companies devastated and, in some cases, the complete collapse of business models.

Wide berth

Now and in future I'm going to be more reluctant to invest in companies facing a difficult future. Right now, there are a lot of seemingly cheap pockets of the market to which I'll be giving a wide berth. Discretionary retail—or any business with significant exposure to discretionary spending—and 'old media' are top of my list.

We've written much about old media's travails, including my special report on the 2006 Berkshire Hathaway AGM, and *Time to cancel your newspaper sub* in February 2007, when we slapped Sell recommendations on each of the listed newspaper stocks. I won't repeat those arguments here. But I won't be touching these businesses, especially the heavily indebted ones like **Fairfax** and PBL Media (part owned by **Consolidated Media Holdings**), unless they are given away.

And I feel the same about exposure to the discretionary consumer dollar. Although the issues are more short term, whole industries and retail infrastructure have been developed during a decade of consumers spending more than they earn. Adjusting our economy to lower levels of spending is going to be more painful than most investors realise. I expect many businesses will struggle to survive.

So that's the background to my selections. Although one of my three has more than its fair share of structural issues, I've tried to pick stocks where the underlying businesses don't face too many fundamental challenges, and where I can rely on them generating an increasing stream of cash.

Infomedia

There's an argument that I'm making exactly the mistake I've described above with Infomedia. The fundamental fault with this business—the fact it's beholden to the auto manufacturers to provide it with the data to make its electronic parts catalogues—has been squeezing the company's revenue and margins ever since we first recommended it more than four years ago.

There's also a more pressing concern at the moment. Between them, General Motors and Ford dealerships provide approximately 50% of Infomedia's revenue and they're currently involved in a desperate attempt to stave of bankruptcy. We looked at what we thought the consequences of failure would be on 10 Dec 08 (Buy—$0.295), but it certainly wouldn't be good news.

So yes, it's possible I'm also underestimating the challenges faced by this business. But this is the selection I'm most comfortable with—this stock will perform well despite those challenges.

It has no debt, a great dividend yield—out of the substantial amount of cash generated by the business—and no exposure to discretionary consumption. So it ticks a few of the boxes. And the challenges are, in my opinion, being overplayed. Not many things are more certain than the fact that humans will still be driving cars three years from now. They will need to get them repaired and that means there will be a business for Infomedia in providing the repairers with the information they need.

The other factor I like is that it is a huge beneficiary of the lower Australian dollar. If it stays at or below its current levels against the US dollar and the euro, Infomedia's profitability will be up to 50% higher than it would have been at exchange rates achieved in the 2008 financial year. That will more than offset any consolidation in the US car dealership industry.

Southern Cross SKIES

My remaining two selections are income securities. For mine, this is one of the most attractive areas of the market at the moment, and I like the idea of realising the value we're finding in cash (as opposed to relying on other stockmarket participants to price a stock higher).

Despite the substantial amount of debt carried by Sydney Airport, the related income securities, Southern Cross SKIES (SAKHA), are one of the safer ones listed on the stock exchange. That's because airports are wonderful assets and Sydney Airport is a particularly wonderful example, with its monopoly over airline access to Australia's biggest city and most popular tourist destination. It is also able to cash in on that monopoly position by charging customers exorbitant prices for retail, car parking and property leases on and near the airport.

The airport completed a refinancing deal with its banks in the first week of December, leaving it with $870m to refinance by the end of next year and then nothing until the end of 2011. The SKIES aren't due to be repaid until January 2012 but, given Sydney Airport's majority shareholder, **Macquarie Airports**, has $1.6bn cash in the bank, we think it's unlikely there will be too many troubles. I expect this security to be trading much closer to its $100 face value in three years' time and pay some nice distributions along the way.

BBI EPS

There is no such confidence about my final selection, BBI EPS. Distributions on these income securities, attached to **Babcock & Brown Infrastructure**, have already been suspended while the group tries to manage its debt burden down from extremely high levels.

The reason I have selected it is because there is a good chance of success. The underlying assets—ports, railways and energy transmission infrastructure, represent a perfect safe haven in what is going to be a very difficult three years for the world economy. Both short and long-term interest

rates have also plummeted which makes the stable, regular cash flows of these businesses even more attractive.

There's no pressing need to sell assets for unattractive prices—the immediate refinancing requirements have either been met or can be met by existing cash balances. And the banks have enough problems with customers that can't pay, like BBI's manager **Babcock & Brown**, to start causing trouble with those that can.

If it makes it through, BBI will be a shadow of its former self and this is obviously a risky situation. But I think the business has a good chance of survival and, with the BBI EPS trading at 12% of their face value, the risks are worth taking.

Steve's Stars

STOCK (ASX CODE)	PRICE AT 10/12/08	MOST RECENT REVIEW
Infomedia (IFM)	$0.295	10 Dec 08 (Buy—$0.295)
Southern Cross SKIES (SAKHA)	$71.00	22 Oct 08 (Buy for Yield—$73.30)
BBI EPS (BEPPA)	$0.12	3 Dec 08 (Speculative Buy—$0.13)

Disclosure: Steve owns shares in Infomedia and SKIES and BBI EPS income securities. Other staff members own shares in Infomedia, and BBI EPS.

Tony Scenna

With the future looking so uncertain, Tony is sticking to some high-quality old favourites.

Picking three stocks for three years is never an easy task. And whereas the situation in 2005, when we first undertook this exercise, was accompanied by buoyant economic conditions, the circumstances this time around are far more intimidating. In fact, depending on whom you speak to, the Australian economy is a stone's throw from entering a recession, if not a deep recession, and the outlook is decidedly grim.

So with this background what have I come up with? I have to say that in all my years involved in the markets, never have I seen so many businesses trading on historical PER multiples that are decidedly less than the dividend yields that accompany them. In fact, the manner in which investors are dismissing single-digit PERs and double-digit yields pretty much sums up the mood and fear of what may lie ahead.

On this point I don't have the foggiest as to how things may pan out, but I do draw comfort from the three stocks I've chosen, because I have a good understanding of each business model, having followed them over many years. My choices may surprise, particularly when you consider the smorgasbord of opportunities available, but I believe each has the opportunity to excel despite the impending clouds.

Flight Centre

Those who have noted my previous recommendations won't be surprised by my first choice, Flight Centre. In my opinion, it ticks most of the boxes. It is a remarkable story that has delivered consistent growth, with strong management input and financial discipline, underpinned by strong internal cash flow that has allowed for business reinvestment. While there are risks, particularly in this environment of slowing growth, management continues to develop a stronger, more comprehensive global travel footprint.

At last count, the group sold close to $11bn worth of travel tickets, earning commissions totalling some $1.4bn and a bottom line profit of $143m. And while the warning bells are flashing that earnings could be hit hard in the current economic turmoil, I'm happy to back this team and its operations over the next three years. As things stand, the group is trading on a historical PER of 6.6 and a fully franked yield of 8.9%.

Reece Australia

My second choice is Australia's largest supplier of bathroom and plumbing products, Reece Australia. Without any fanfare, management has done a remarkable job in growing this business, with extraordinary results. In fact, one of the great things about Reece is that management says very little but their results say a lot. With a history dating back to 1919, the group listed on the stock exchange in 1954. The Wilson family first got involved in 1969 and has carefully steered Reece's progress ever since.

During 2008, sales revenue exceeded $1.4 billion, with earnings before interest and tax of $164 million and a bottom line profit of $114 million. Despite going from 180 outlets in 2001 to 388 in 2008, the group maintains a zero net debt position.

Tony's Treats

STOCK (ASX CODE)	PRICE AT 10/12/08	MOST RECENT REVIEW
Flight Centre (FLT)	$9.64	12 Nov 08 (Buy—$10.86)
Reece Australia (REH)	$15.87	N/A
Sirtex Medical (SRX)	$1.70	N/A

While management has described 2009 as being the most challenging year the company has experienced for some time, it's rare to buy into this group without a significant premium attached. The current turmoil provides one of those occasions and, with the shares trading at multi-year lows, I'm happy to step in and oblige. Reece is on a historical PER of 13.9 and a fully franked yield of 3.6%.

Sirtex Medical

My final choice is Sirtex Medical, which specialises in treating patients with advanced liver cancer by targeting internal radiation directly at the tumors. Patients at this

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Tony Scenna [CONTINUED FROM PAGE 9]

advanced stage often have few options and the industry's standard treatment—chemotherapy—offers little hope.

The company listed on the Stock Exchange in 2000, raising just $15m. Today, it has succeeded in taking its lead product, SIR-Spheres, to the global market, with relevant government health approvals in place in Australia, Europe and the USA. While the company has had its fair share of controversy, related to patent disputes surrounding inventor and past chief executive Bruce Gray, the group has weathered the legal process and has been vindicated in its actions.

Current management has undertaken the necessary steps to build a solid base, investing in all facets of the group's operations. Importantly, Sirtex owns its technology outright and has invested considerable sums to support a growing sales and marketing team. Worldwide, Sirtex's SIR-Spheres treatment is now offered to patients in 198 treatment centres, including 132 in the United Sates, 37 in Europe and 29 in the local Asia Pacific region. To date, 8,300 doses have been provided, with sales revenue hitting $38m during 2008.

While the risks are high, the group's progress has been good and management's view of the future is decidedly positive. SIR-Spheres is not a cure, but the indications are that it has become an important treatment option. The shares are tightly held and rarely trade, and Hunter Hall Investment Management is a major shareholder with some 28%. Over the next few years, it is certainly possible to see the group's revenue hit $100m, along with an operating margin of around 35%, implying a bottom line profit of $24 million. Under this scenario, Sirtex's current market capitalisation of $95m would look decidedly low.

Disclosure: Tony holds shares in Flight Centre and Sirtex Medical. Other staff members own shares in Flight Centre.

James Carlisle

Quality came through for our editor James Carlisle in our previous contest, but can he manage a repeat performance?

Most of my investing is based on the premise that the market tends to pay too much attention to the short term and too little to the long term. So I'm wary of companies where the short-term outlook is better than the long-term prospects (eg current fads and companies in declining industries) and I look for opportunities where the reverse is the case—generally the very highest quality businesses, or decent businesses going through a rough patch. Then there are the wild irrational punts, but this is a family publication and the less said about them, the better.

Anyway, I tend to favour the very high-quality businesses, because I find I'm better at picking them than I am at spotting the difference between short-term hiccups and long-term decline. But it all depends on price, of course. Sometimes the best businesses are also the current fad and, while they're rarely overpriced, they may not be huge bargains. And sometimes there's such a margin of safety with the decent business going through a rough patch that it's hard to ignore.

Given the recent 'flight to quality' on account of the financial crisis, we're probably in this sort of a situation at the moment, but then going into a downturn of unknown severity, quality probably deserves as much of a premium now as it ever did.

Market blasé about debt

The other point I'd make is about debt. I've always liked companies with low capital requirements and strong free cash flow, and these of course have little need for any debt—so long as management is strong enough to withstand the pressure from impatient investors to make their balance sheet more 'efficient' or set off on an acquisition binge. So, if a company is loaded up with debt, you have to wonder why, and it's often a sign of a weak business, weak management or both.

In the current environment I think the market is still being too blasé about debt. Banks don't want to lend to anything less than the best risks—at least at rates that won't bankrupt them anyway—and there will only be so much to go around. I think we'll see the ownership of a good many more businesses transfer from shareholders to banks over the next few years.

I might be wrong about this, and I can understand why people would make the contrarian bet that the gloom about debt has been overdone. They might be right, but if you're picking stocks on the basis of long-term business quality, debt is a wildcard that you just don't need. It's not for me anyway.

Flight Centre

Top of my shopping list at the moment is Flight Centre. I've been absolutely astonished by this stock's movements over the past few years. After tripling in the space of two years, we're now roughly back to where we started, and yet the long-term value of the company has hardly changed at all. All we had was a year when the company hit all its override targets and made a stack of money, and the market got carried away. Now profits have stalled for a year and the stock's back in the doghouse. Never has the market's myopia been more starkly illustrated.

Perhaps profits will go backwards in the coming downturn—maybe quite a bit—but I'm prepared to bet good money that they'll beat last year's profits when we come out the other side, and that the company will continue to grow

until we hit another downturn. 'Prepared to bet', that is, rather than 'have bet', because I invested all my loose cash back in June, which seemed like a good idea at the time (and still does—though I'd rather be investing it now!).

Flight Centre's great strength lies in its brand and culture. The former gives branch managers and sales staff the platform from which to win business and the latter provides them with the incentive to do so. My wife and I are currently operating a smartie-based incentive system to toilet train our son and I can concur with Graham Turner's view that 'what gets rewarded gets done'.

No doubt the internet is a threat to Flight Centre, but long-haul flights and big holidays are a large and relatively occasional expense and I think people will want to talk to someone before committing. And Flight Centre has a reputation for fair dealing and best prices that takes many years to build.

Increasingly uncomfortable

My biggest bet at the moment is on the fund management sector, where I hold **Platinum Asset Management**, Treasury Group and Magellan Financial Group. I could have picked any of these for this contest, but I've settled on Magellan.

This company can hardly be called high quality—it's only been around a couple of years and hasn't made any money yet—but it invests in a lot of companies that undoubtedly are. The group's philosophy is based on value with an 'extreme quality overlay' and, as I explained at the beginning, I tend to expect the highest-quality companies to outperform over time—it's hard to give them enough credit for their long-term strengths, particularly when there are other businesses doing more exciting things in the short term.

The two main movers in Magellan, Hamish Douglass and Chris Mackay, are also big fans of Warren Buffett and Charlie Munger—and it's not just talk, Douglass has attended ten Berkshire Hathaway AGMs. Putting it all together, I'm prepared to back them to establish a decent track record over time. The evidence so far, such as it is, is good, with the Magellan Global Fund actually delivering a positive return (of 5%) in the year to 31 October, compared to a loss of 18% for the A$ MSCI world index.

They say they expect to make money on an underlying basis this year. That seems a little optimistic—at least I'd rather not bank on it—but it doesn't really matter because, with around $93m in liquid investments and cash (as at the end of October), they can afford to take their time. And of course the cash and investments comfortably cover the company's current market capitalisation of $69m. They'd have to burn money at quite a rate for quite a time to get it down to that and I don't see that happening.

Infomedia

For my final pick I'll go for Infomedia. This company is probably at the lower quality end of the spectrum I'd normally look at, because it has an awkward competitive position, being dominated by a limited number of suppliers—the car manufacturers—on whom it depends entirely for the data to make its catalogues.

On the other hand, these products do add a lot of value and car manufacturers—particularly the American ones—currently have too much on their plate to worry about revenues the size of Infomedia's. No doubt people will get their cars serviced less regularly during a downturn, but Infomedia's customers—the dealers and service agents—are relatively weak, being very numerous for one thing, and its product is a small and fixed cost to them.

Carlisle's Crackers

STOCK (ASX CODE)	PRICE AT 10/12/08	MOST RECENT REVIEW
Flight Centre (FLT)	$9.64	12 Nov 08 (Buy—$10.86)
Magellan Financial Group (MFG)	$0.46	N/A
Infomedia (IFM)	$0.295	10 Dec 08 (Buy—$0.295)

So the company's quality is something of a mixed bag, but it has net cash, generates plenty more, and the price—which amounts to a PER of just over 7 based on 2008 earnings—looks very cheap.

Disclosure: James owns shares in Magellan Financial Group and Infomedia. Other staff members own shares in Flight Centre and Infomedia.

Top stocks contest goes to the wire

The following is an extract from the wrap-up to our previous top stocks contest. For the full article, including each analyst's comments on their selections, see issue 261/Nov 08.

Three years ago our analysts each picked their top three stocks to hold for three years, and after some toing and froing and a fair bit of argy bargy, the results are now in.

And you thought this year's Melbourne Cup was exciting. Coming into the final week of our 'top three stocks for three years' contest, Brad Newcombe had a commanding lead, but a tired finish from **Flight Centre** and a final flourish from James Carlisle's **Cochlear** gave us the statistical equivalent of a photo finish—we had to go back and extract an extra decimal place from our spreadsheet. After reviewing the tape, James Carlisle had edged ahead by a margin of four hundredths of a percentage point, which isn't a lot over three years it's safe to say.

James's winning mark was a return of 28.94% (8.8% pa), which compares to the 8.1% fall (2.6% pa) in the All Ordinaries Accumulation Index over the period. *The*

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Top stocks contest goes to the wire

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Intelligent Investor's average performance was a loss of 4.0%, which is disappointing—it's never nice to lose money—but represents a reasonable outperformance of the market in challenging conditions.

Bear market in perspective

The returns also provide a bit of perspective to this year's stockmarket falls—we might be a long way down this year (our average return this time last year was a gain of 58.6% compared to a gain of 54.3% for the market), but we're only back to where we were about three years ago, which is hardly a disaster in the grander scheme of life.

The individual performances cover a wide range, which is just what you'd expect from portfolios (if you can call them that) of only three stocks. The underlying stock performances ranged from a return of 120% for **JB Hi-Fi** to a complete wipeout (near as dammit) from Croesus Mining. These two stocks also filled the top and bottom positions a year ago, but between them the positions have been shuffled significantly, with **Flight Centre** and **Harvey Norman**, the second and third placed stocks a year ago, dropping to fifth and eleventh on the list, respectively, as the consumer downturn begins to bite. The performances of all the stocks chosen in the contest are shown in the chart below.

Takeovers a bonus

It's interesting to see Colorado (the retailer taken over by private equity interests—remember them?—in 2006/7) and Carter Holt Harvey (the timber company taken over by Graeme Hart's Rank Group in 2006) moving up to second (from seventh a year ago) and eighth (from twentieth). It seemed natural to assume it was a handicap to have a stock taken out of the race with a takeover, and its return cast in aspic, but with the market taking its tumble it's turned into quite a bonus.

The winner had all three of his stocks—**ARB Corporation**, **Cochlear** and **Westfield Group**—in positive territory, and it would be tempting to go on about the importance of not losing money. But Tim Searles managed third place with a portfolio that included both JB Hi-Fi and Croesus (with Flight Centre completing the portfolio), and he was leading the contest until recently, showing that big winners can overcome big losers. With big winners hard to come by recently, however, avoiding the losers seems to have made the difference.

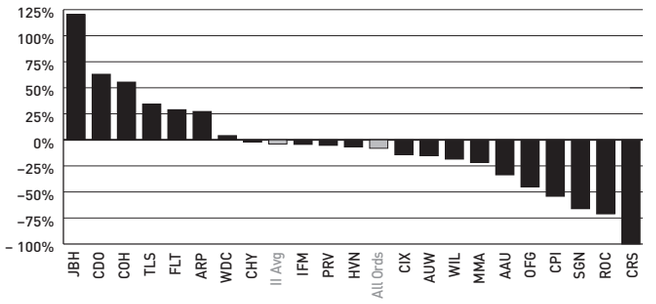
Wrapping up

So that wraps up our little competition. The figures from three-stock portfolios over three years don't tell you much, but there are still a few interesting lessons to take away. Probably the main one is the importance of diversification—even very capable investors get widely diverging results from such focused portfolios.

There also seems to be some support for investing in quality, but that may only be a feature of the past few years, and of course it all comes down to price in the end. Certainly you make life hard for yourself if part of your portfolio doesn't finish the race, although Tim Searles's performance shows that such a handicap isn't insurmountable if you can find a big winner.

One final point raised by several members of the team is the importance of dividends. It's easy to forget about these when assessing a stock's performance, but they can make a big difference to the final wash-up. Westfield, for example, slumped from $17.02 to $14.50, but still managed to provide a positive return after the inclusion of dividends. **Telstra**, Flight Centre, **Premium Investors** and **Infomedia** are other examples where dividends made a hefty contribution.

Top 3 for 3 final returns



DISCLOSURE As at 10 Dec 2008, in-house staff of The Intelligent Investor held the following listed securities or managed investment schemes: AEA, AHC, ANZ, ARP, AWE, BEPPA, CBA, CDX, CHF, COH, COS, CRS, CXP, DBS, FLT, GFF, GLB, GNC, GTP, HVN, IAS, IDT, IFL, IFM, IMF, IVC, KRS, LMC, LWB, MFF, MFG, MLB, MMA, MOC, MQG, NABHA, NHF, NVT, OEQ, PMV, PTM, REX, RHG, ROC, SDI,SFC, SFH, SGB, SGN, SHV, SIP, SLM, SOF, SRV, STO, TEN, TGR, TIM, TIMG, TLS, TRG, TRS, TTS, VBA, WAN and WDC. This is not a recommendation.

DATE OF PUBLICATION 10 Dec 2008.