Investment Managers Report

DEAR SHAREHOLDER

OVERVIEW: QUALITY AND VALUE

MFF's portfolio companies are demonstrating their quality in terms of strong current operating performances, increasing market shares and sustainable structural competitive advantages (Quality).

Although share prices have risen strongly, MFF's portfolio valuation retains a significant 'Margin of Safety' (Value). Share prices were abnormally low in the panicked conditions at the end of 2008 and in early 2009, and we moved to be fully invested. We have continued to be almost fully invested and we believe that valuations remain attractive in terms of their foreseeable future cashflow generation.

During the depths of the financial crisis, we resolutely focused on Quality and Value and we will continue this approach, as we believe that it maximises the probability of attractive risk adjusted returns whilst minimising risks of permanent capital loss. Over coming decades, our companies will reinvest billions of dollars of operating cashflows from their increasingly productive and efficient developed markets leadership into market leading, profitable positions in emerging markets as well as in new products, distribution and innovations. The financial crisis gave us the opportunity to buy some outstanding companies at extraordinary prices (in some cases below prices ten years or more before, despite significant gains in profitability).

Hamish Douglass, my key business partner, and I are increasingly confident about the business prospects for our portfolio companies. The crisis is taking a severe toll on competition. Our companies' competitive advantages are being strengthened, and we believe they will likely be sustained for decades across multiple major markets. Management and business cases have been tested during the crisis and we believe that winners will become even more obvious over coming years. Execution focussed leaders are expanding volume steadily, maintaining pricing power, innovating well in multiple markets, and improving productivity to improve margins and earnings.

Given the likely return of inflation in some geographies and industries in the context of a world of broad overcapacity (which is deflationary), it will be more important than ever to have strongly advantaged businesses and management teams that have successfully navigated crises over the decades. We are very conservative about the interest rate and discount or hurdle rate assumptions that we use, as there is real risk of further significant supply/demand distortions given the reliance on global funding flows. We also believe that the unhedged Australian dollar position is conservative and has reduced volatility, as shown during the crisis when MFF's portfolio materially outperformed in part because of favourable currency movements.

Although financial armageddon has been avoided (in our view), investors have much to worry about on the economic and political landscapes, obviously including sovereign debt and the risks relating to stimulus unwinding. Some markets may have rebounded too far but confidence generally remains fragile. We are monitoring some major macroeconomic risk factors such as the magnitude of sovereign debt financing requirements, which was moved from being a 2009 problem by excess capacity, low official interest rates and quantitative easing.

Investor concerns about the near term outlook can enable attractive purchase prices. Hence we were able to buy stocks such as Coca-Cola in 2009 at well below fair value. Their recent results disclosed their 26th consecutive quarter of double digit volume growth in China (29%), annual volume growth in India of 31% and an overall 8% increase in 2009 operating cashflow to US$8.2 billion. Their broadening product line and multi billion dollar investments in many markets and product extensions mean that it is virtually certain that Coke will continue to increase its market shares and product volumes over coming decades.

The extraordinary values of our companies' emerging markets businesses are 'hidden in plain sight'. In the early 70s, investors pushed the market values of the so called Nifty Fifty companies, including McDonald's, to extremely high levels relative to their then prospects, as they were regarded as one stop companies to benefit from global growth. In time, the highest quality companies will again command a premium, as they pick up profitable market shares and strengthen their competitive advantages around the world, whilst concurrently demonstrating strong defensive characteristics in many established markets. We also believe that current emerging markets' earnings for our companies materially understate their potential.

HALF YEARLY RESULTS

MFF recorded a net profit after tax of $30.7 million for the 6 months ended 31 December 2009. This profit principally reflected unrealised increases in share prices over the period, partially offset by unrealised foreign exchange movements. The approximate Net Tangible Asset (NTA) backing per share (excluding deferred tax assets) increased from $0.63 to $0.754 in the period. Including deferred tax assets, the NTA per share as at 31 December 2009 was approximately 84 cents per share.

MFF's NTA per share increased in the 6 months period by approximately 19% and this exceeded the rise of global indices (in AUD terms) of approximately 9%.

Since half year end, global markets have again been volatile, but MFF's NTA has been far less volatile as many of MFF's leading companies have reported current earnings and outlooks that confirm their advantaged positions and the AUD came back from recent highs.

MFF'S PORTFOLIO

Portfolio turnover remained low during the 6 months. We are happy with MFF's companies and valuations. We believe that some valuations remain absolutely compelling. Short term market movements are sometimes simply wrong, and no indicator of long term prospects [consider the halving in Coca-Cola's share price shortly after listing in 1919 in response to rising short term commodity prices (sugar)].

The portfolio is concentrated in companies that combine well above average business resilience with above average future growth opportunities. Their business cases are strong. Some of the most consistently profitable industries in the world are being defined by a small number of winners, and their steadily increasing advantages are translating over time into materially higher market shares and cashflows and materially lower competitive threats. Some of these companies are becoming the leaders in the largest 'emerging' markets such as China, India, Brazil, Russia, Mexico, Indonesia, South Africa, Egypt and Turkey, as well as leading in North America, Europe and Japan. These companies often remain at very attractive valuations given the impact of the crisis on current earnings and as record investment flows chase growth in emerging market mutual funds and ETFs rather than invest in European and North American multinationals which trade at far lower price/value metrics and have superior governance, transparency and managements.

Yum! Brands recently disclosed that its calendar 2009 operating profits in China had tripled over 4 years to US$602 million and the company recorded its 8th consecutive year of double digit earnings per share growth (despite significant ongoing weakness in the US which continued in 2009). Such figures illustrate a virtuous cycle for the very small number of companies with profitable market leadership in multiple markets generating strong recurrent cashflows, product development and management talent to enable further targeted growth, and further reinforcing their competitive advantages and profitable market leadership. Coca-Cola's unit case volume rose 29% in China (which is already Coke's 3rd largest market). In contrast, top 5 soft drink company Cott Corporation required an emergency US$47.4million capital raising in 2009. Top 5 Quick Service Restaurant (QSR) Group Burger King has had to cut back capital expenditure for 2010 as its latest 6 months group profit remained flat at US$96.8million. The reinvestment potential of each US$1 billion is much greater post crisis than pre crisis for the strongest companies as distributors and suppliers may be struggling to finance operations, and advertising and real estate budgets stretch further.

MFF's Top 20 holdings as at 31 December 2009 are shown below:

	A$M value at market price		A$M value at market price
American Express	62.5	Tesco	9.9
Nestlé	39.6	Wells Fargo & Co	9.1
Yum! Brands	32.1	Colgate-Palmolive	7.1
Wal-Mart Stores	29.7	Bank of America	6.3
eBay	26.8	Visa Inc	4.9
PepsiCo	17.5	Lowe's Co Inc	4.9
Google	17.4	Unilever NV	4.8
Coca-Cola	16.0	US Bancorp	4.3
McDonald's	14.6	Ferrovial	3.4
Procter & Gamble	12.2	Johnson & Johnson	3.1

Movements in the Top 20 in the six months almost entirely reflect price changes in the period, as there were only very modest increases or decreases in holdings. We added Wells Fargo and Kraft (outside top 20), as we believe that they are compelling and MasterCard was sold based on relative valuations. Some sales are required to fund the share buyback and to ensure gearing is below 20%. We will also continue to have some movements in the portfolio composition as relative opportunities emerge, particularly from price/value movements.

Our portfolio has a significant and growing weighting to emerging markets, and in many cases we have the #1 (and profitable) category position in the major emerging markets. These category "winners" have made significant capital, brand, product and management commitments over many years. Scale should be an advantage as hundreds of millions or billions of dollars are required to develop in the key emerging markets, as is skilled experienced management.

We want sustainable structural competitive advantages, ideally where there is a strong probability that these advantages will grow over time. Yum! has developed its China business over more than 20 years. During their recent earnings conference call, the Yum! CEO, David Novak, said that there wasn't a lot of global competition in their category in China, except for McDonald's and that the local competition primarily consisted of some chains in Chinese food in Shanghai and Beijing .Yum! is often the only QSR in tier 4, 5 and 6 cities in China.

Nestlé again increased market shares, global sales, operating cashflows and competitive advantages in 2009 with its disciplined, multi product, multi country, medium term focussed strategy. They are converting their investment in leading eyewear company Alcon of a few hundred million dollars in the mid 1970s into after tax cash proceeds in excess of US$40 billion. These proceeds, and Nestlé's CHF17.9 billion 2009 operating cashflow, benefit shareholders through a combination of buy backs, increased dividends, targeted acquisitions and organic reinvestment focussed on emerging markets, product development and distribution improvements.

We predict that McDonald's will continue to profitably increase its customer numbers (which rose from 58 million to 60 million per day in 2009). McDonald's is constantly refurbishing its stores and menus and also stepping up its investments in markets like China and Russia where it is already well established and profitable and can readily fund this expansion from earnings (US$4.6 billion NPAT for calendar 2009) [McDonald's celebrated its 20 year anniversary in Russia in early 2010, as Burger King opened its first outlet].

McDonald's has had the best US same store sales performance of any major retailer throughout the crisis (with the possible exception of Wal-Mart) despite the rising unemployment. This is extraordinary and contrasts with the overall QSR industry, as young construction workers, an attractive primary demographic for QSRs, have been heavily impacted as U.S. housing starts have fallen from over 2 million mid decade to about 544,000 in 2009. If the forecasts disclosed by Caterpillar as part of its recent outlook statement are achieved, US housing starts will recover somewhat to about 1 million this year and eventually rise back to the national replacement rate of 1.5 – 1.6 million per annum. We expect that McDonald's will be a beneficiary of the inevitable recovery in these markets, as well as its ongoing global improvements as they translate customer insights into customer habits and into profitable structural competitive advantages by serving restaurant guests of every age, speaking every language, 24 hours per day via high quality procurement systems and supplier partnerships.

We increased our holding in American Express in 2009, including small purchases at below $10 per share during the March panic. Although American Express was the strongest performer of any company in the Dow Jones Industrials Index in calendar 2009, and the price has risen to about $40 per share, we believe that American Express continues to have considerable upside.

American Express continues to enhance its attractive customer value proposition. The combination of excellent rewards, security and service earns the loyalty of many affluent customers and enables mutually profitable partnerships with merchants and average customer spend of about 4 times greater than alternatives. We look closely for weakening in these competitive advantages but have not seen it in this crisis. American Express has actually done far better than in previous recessions by adding new merchants and rewards partners, maintaining card usage and other key metrics. In Australia each of the four major banks now promotes co-branded American Express cards offering rewards points far above their standard cards as well as other enhanced benefits. American Express' most elite and corporate service offerings continue to be enhanced with unique valuable benefits.

American Express remained profitable every quarter through the crisis, maintained its full dividend, was #1 ranked in the US financial system 'stress test', has returned to positive billings growth and industry leading credit metrics, generated US$29 billion in customer deposits, maintained excellent net interest margins, discount rates and fee income and is investing heavily in future growth opportunities.

During the crisis, we spent a lot of time with management of American Express as well as making our own detailed analysis of their funding, liquidity, capital and other metrics. We also examined data and spending patterns and observed card usage to look for a decline in usage, particularly amongst the core affluent and corporate customer bases. American Express subsequently released data which confirmed that merchant acceptance rose, card numbers were broadly steady (excepting American Express' credit related initiatives), co-branded cards continued to rise and the number of transactions per card were steady even though average spend reduced in the 'new normal' economy. Aggregate figures showed market share gains for American Express and the continuing secular shift from cash, although debit cards are growing far more strongly than credit cards.

Payments industry participants, banks, retailers and other merchants, regulators and advertising companies (on line and traditional) continue to give us valuable insights in considering American Express' likely future earnings profile, risks and competitive positioning [Visa, eBay (PayPal), MasterCard and other payment space 'winners' are a key focus area for MFF]. We have confidence in American Express' senior management team, although the crisis exposed losses from their previous lending growth and required corrective action. Their prompt, industry leading action on credit reflect the competitive advantages of American Express' 'diversified but focused' payments space focus and affluent customer base and much shorter typical repayment schedules than for traditional loan products such as mortgages.

American Express managers have planned the exit from the crisis from a strategically advantaged position. American Express used the crisis to establish more diverse funding sources, it does not have broader systemic risks and is not 'too big to fail'. Foreseeable risks appear to relate to the level and timing of profitability rather than fundamental risks, although regulatory risks remain a particular concern for financial industry participants. American Express also continues to focus on responding to the shift to debit cards and in particular will seek to have users replace some debit usage with its charge card products. Given the resilience of their core affluent and corporate bases, and obvious growth potential in Global Network and Merchant services, we regard competition in the debit usage space as well as internet, mobile, B2B and emerging market payments as potential areas of upside opportunity.

We expect that, in time, investors will consider that the crisis has passed and American Express will earn much higher or 'normal' earnings, will again demonstrate growth potential and be priced by investors at higher multiples of those increased cashflows and earnings.

During November Coca-Cola presented its 2020 Vision, including that they expect to generate operating cashflow to 2020 of US$130-150 billion and free cashflow (i.e. after capital expenditure) of circa US$100 billion for the period. This is realistic and we are very confident that the global market share of Coke products will increase from the present 1.6 billion per day and we also believe that Coke has sufficient pricing power to increase the average profit per serve accruing to it from the 2009 level of slightly over US1¢ (after tax). In China, Coke has moved to strong market leadership in juice and is rapidly building its national production and distribution capability, and consumption will almost certainly increase materially from 100 million units per day. We bought heavily into Coca-Cola in 2009 and are confident that Coke is likely to be very valuable in 2020, after delivering and deploying free cashflows in excess of our purchase price.

Wal-Mart's recent strategic presentation included the simple maths that their market value approximated the value of the cashflows of their existing operations, assuming no additional value for ongoing productivity improvements and their obvious growth potential. Wal-Mart's competitive advantages include its US $138 billion (at cost value) of property plant and equipment built up over 47 years.

Wal-Mart has materially increased its cashflow generation in recent years (2009 US$26.2 billion operating cashflow from US$405 billion in net sales) and it continues expanding shopping space by about 4% annually. Wal-Mart's value and brand offer is steadily improving in the US and around the world as it successfully combines its global sourcing, knowledge, IT and logistic advantages with strongly focussed local management.

We are confident that by 2020 Wal-Mart will have materially increased its profitable penetration in its focus markets. In the US, Wal-Mart is benefitting from a significant productivity loop where its sales per square foot are 3 times or more competitors such as Sears/Kmart which had very similar store area coverage until slowing recently. We expect Wal-Mart's almost 10% overall US market share to grow and its historically very low store brand penetration to increase materially in combination with an intelligent focus on the fastest moving, profitable #1 and #2 ranked branded products (many of which are sold by MFF companies).

Wal-Mart has the best brand and value positioning in its categories (Save Money, Live Better) and Wal-Mart also has considerable international growth options, particularly in Latin & South America, including Brazil. Wal-Mart's US operations have adopted the customer targeting used successfully in Mexico by the Ecuadorian born chief executive of its US business (Eduardo Castro Wright). Similarly, successful initiatives for Latino communities at Wal-Mart in Mexico and the US are being adopted elsewhere in Latin and South America, and the reverse is true. Wal-Mart is already #1 in Mexico and the latest 6.1% year on year January 2010 traffic increase from Wal-Mart Mexico is stunning. Wal-Mart is one of the best positioned companies to address the needs of multi-lingual, youthful, aspiration and populations in the US, Latin and South America.

Although economic ups and downs and currency movements impact upon year to year profits and translations, the best companies continue innovating and continue growing their profitable sustainable competitive advantages. The recent 50% devaluation of the Venezuelan Bolivar is significant for companies with operations there but hasn't prevented Colgate-Palmolive increasing its dividend 20% (after another double digit profit increase in 2009 and another forecast for 2010), or prevented Procter & Gamble from targeting another billion consumers of its products (to almost 5 billion annually) and further increases in average consumption of P&G products by 2020.

In economists' terms we see continued benefit to our companies from increased Ricardian growth (i.e. a bigger pie because countries focus on their relative competitive advantages) and Schumpeterian growth (innovation and technology) which requires reinvention as they have the most capacity to spend productively on reinvention and on sustaining significant competitive advantages. Similarly when considering the insights of Richard Florida into successful cities, we believe that ongoing, necessary urban renewal is very difficult but most possible in mobile multi lingual diverse and wealthy market based, mixed economies with very strong tertiary and post graduate education (US for example) as opposed to continues with less dynamic or unfavourable demographics. Even in instances of Malthusian excess demand overriding technological improvements, their financial strength gives them the financial capacity to enter into long term preferred relationships with suppliers that they have helped develop on the ground in emerging markets (Nestlé, McDonald's, Yum!, Unilever, Procter & Gamble, Wal-Mart and PepsiCo are obvious examples). Achieving significant sustainable IT and logistic benefits from global production and sourcing should be less risky for these branded high turnover companies than for most others, including longer line manufacturers such as Boeing and Toyota.

Seeking to understand competitors and market dynamics is important and, we believe that Cadbury's situation illustrates that the challenges of reaching the most profitable global leadership elude almost all companies. Cadbury acquired and built up the global #3 non alcoholic beverages company but could not compete globally with Coke (in particular) and sold in pieces, including the spin off of Dr Pepper Snapple (North American focused and profitable but a significant proportion of its product is distributed by Coke and Pepsi).

Despite sensible acquisitions and management improvements, we felt that Cadbury's confectionary business produced insufficient free cashflow over time to fund a true emerging markets footprint to compete with established regional brands and Mars/Wrigley and Nestlé in particular. Even high quality products, such as Cadbury's, require considerable investments of capital and management to penetrate in multiple markets.

In our view, the combination with Kraft gives the combined group the scale, products, distribution, cashflows, relationships with suppliers and major retailers and management bandwidth to materially increase the probability of being one of the small number of 'winners" that will be entrenched in consumers' minds around the world when they consider chocolate and confectionary products. Setbacks in individual markets can be met, as can the necessary investment to build presence in consumers minds in markets such as China. The competitive advantages against regional and local competitors are more tangible than for Cadbury as a stand alone company. We expect that Kraft will improve the penetration of Cadbury brands in North America and Europe and the combined brands and products will improve in emerging markets.

Our view is that Procter & Gamble is the global FMCG gold standard in building multiple strong cashflow and margin products and markets, particularly the largest, most profitable and those with the most potential. P&G is also the template for the successful multi product multi market complementary acquisition of Gillette. Kraft's high quality highly cash generative portfolio is underrepresented in emerging markets and growth categories and, hence, Kraft has paid up (in our view) to address the realities of global competitiveness for itself. The market's selloff of Kraft during the takeover period materially widened the Margin of Safety for Kraft shares, even allowing for the price they paid for Cadbury. We expect that Kraft will invest heavily in technology, market, product and brand development, distribution, management and systems to seek to achieve the acquisition benefits.

ECONOMIC / MARKET COMMENTS

There is a lot that investors, politicians, voters and business people are worried about, and much for them to be worried. There should always be a lot to worry about (although wars and crises of the past were overcome) and lack of worry equates to complacency and unnecessary risk taking. However, most of the major foreseeable concerns will have less impact on whether our companies increase sales and market shares and double their free cashflow over the next 10 years than the likely impact on other companies. Despite excellent responses over the past decade, terrorism and pandemics remain as serious global concerns which can impact everywhere.

We spent time in China at the end of 2009 and again early this year to listen to officials, companies, investors, academics and others. Current market concerns are that China is in a speculative boom with excessive unproductive investment, and that the People's Bank of China and the Government will tighten decisively as its highly talented officials (including many US postgraduates) seek to maintain China's historically unprecedented multi decade combination of sustained rapid growth and massive societal restructuring. Such concerns may be uppermost for leveraged purchasers of shares in Chinese growth companies at 60x earnings, for speculators building additional non pre-committed office space in cities with 25%+ existing vacancies or residential apartments priced at multiples of disposable income.

Whilst it is inevitable that emerging markets, including China, will slow and will have economic reversals and that the massive speculative flood of money into emerging market, commodities and similar funds will in aggregate yield volatile returns, such investment booms are actually built on 'significant truths' and usually leave behind very valuable infrastructure and investment. The "cheap" speculative capital is advancing the development of these emerging markets and building valuable communications, other technology, transport, health and educational infrastructure which inevitably will further lift standards of living. The very near term figures may indicate a strong rebound in exports and China's productive capacity utilisation.

As an aside, the trillions of dollars that went into the internet boom of the 1990s produced terrible aggregate returns for investors. Only 2 internet specialist companies earned US$1billion NPAT in 2009 (eBay and Google). However, the societal benefits of the expenditure were enormous, and continue to accrue. Interestingly, many of the most established 'traditional' industry leaders benefitted most from the internet economy because of their methodical focus on widening their competitive advantages. These companies are even more predictable ongoing beneficiaries of the emerging markets investment boom, irrespective of whether individual country stock and property markets boom or bust from time to time.

Although investment levels will likely taper off as emerging economies slow, a classic 'bust' is not inevitable. Each year of increase in average incomes and wealth adds to the sustainability of rises in living standards. Irrespective of short term moves, we believe that it is very likely that China moves from US$4,000 per head GDP to at least US$10,000 per head based on the accruing benefits of existing spending, export competitiveness and technology as well as likely purchasing power parity adjustments. In those circumstances the Chinese consumer market is likely to exceed US$5 trillion with further rises to come from the inevitable mix shift in favour of consumption over time.

If the above 'helicopter view' of China occurs, and is mirrored in the other larger emerging markets such as Brazil (with a circa 200m youthful population), MFF's portfolio companies are likely to be disproportionate beneficiaries. A number of 'local' companies will also succeed in individual markets (and we are watching various companies and markets closely), but in most cases investors already pay far more for these companies as a proportion of current and foreseeable earnings. If there is a classic 'bust' many of these local companies are much riskier than MFF's portfolio companies, particularly at current market prices.

Sovereign debt is a significant concern, including in Japan and various European countries. Default is possible. Austerity budgets and IMF/EU bail outs are likely. US policy positions worry business and investors, particularly as global interest rates are artificially low and the funding for the US (and elsewhere) relies on international investors to supplement domestic savings. As surplus countries invest in offshore assets to diversify, manage local currencies or in chasing better returns, contagion and panic are again possible as regulators and politicians do not have easy choices. We stress test our Margins of Safety by using higher discount rates and conservative forecasts. 'Crowding Out' (higher interest rates and/or higher borrower margins) will be the reality for budget and balance of payment deficit countries requiring growth, whatever Australian and other politicians say, particularly after Quantitative Easing finishes. MFF has some protection as many of our portfolio companies have better credit metrics than medium sized sovereigns (and are subject to less political pressure).

The significant levels of overcapacity in many industries and particularly labour overcapacity, will make it difficult for countries to inflate their debt problems down to more manageable levels. Damaging inflation obviously poses most risks for developed countries which have reversed labour market reforms and in emerging markets, and some emerging markets will export some of their increasing labour costs. Unwinding of fiscal and monetary stimulus is extremely difficult with continuing high unemployment, downward pressure on labour rates from emerging market competition, lack of domestic savings, very internationalized capital flows and an era of instant information and communication. The distortion between much higher wage and benefit public sector jobs and lower average wages and benefits in economic growth generating private sectors will ultimately need to be reversed, if developed economies are to resume aggregate sustainable growth.

MFF's portfolio is focused upon high return on invested capital companies with well above average structurally advantaged shields against both inflation and deflation. We are confident that Google, for example, which has earned US$2.5 billion of free cashflow for each of the last two quarters, will benefit if inflation pushes up the bidding prices for its ads and will continue to be resilient in deflationary conditions. The most successful consumer companies tell us that they are increasing their proportions of digital advertising and commerce as part of a multi year secular global shift.

It is possible that the world concurrently has both excessive inflation and deflation in different countries and sectors. The most efficient global leading companies with considerable localised exposure to the fiscally strongest emerging markets are relatively well placed in most foreseeable economic conditions.

Oil prices are a critical economic variable and we continue to watch oil exploration, production and utilisation data. Recent year declines in US and European oil usage has not yet been fully absorbed by demand increases from China and other emerging markets. Energy usage efficiency is increasing, considerable resources are being allocated to further technological advances and oil usage figures will be watched closely in the recovery. Technology also continues to increase well life and new discoveries and Iraq's mooted 10 million barrel per day capacity are significant. Despite the huge speculative flows into commodity funds and in oil hoarding, the recent oil price spike peaked well below 2007 levels and OPEC appears comfortable with US$70-$85 per barrel levels, with Saudi Arabia retaining considerable excess capacity. Ongoing political events remain problematical, and contribute to upward price pressure offsetting the positive trends.

Efficiency continues to rise in most agricultural production in many areas of the world, but demand is rising steadily with increasing population and affluence. Most of our food companies have entered partnerships to secure sustainable supply and improve local productivity. Even so, most food companies expect agricultural price inflation to resume and they will seek to manage the risks.

Political risks and excessive regulatory reform are ongoing risks. MFF's portfolio is exposed to a decent share of this, as our companies are profitable and one of the sources for Governments. Outside of financials, this will primarily impact the level of after tax profitability although increases in regulation inevitably follow crises. Within financials, we believe that our few, select financials are fundamentally well placed with very strong deposit bases, core profitable franchises and well disclosed asset exposures. The competitive advantages of our 3 banks include generating about 50% of all mortgages in the US (the largest market in the world) and having customer deposits of almost US$1 trillion, including about $300 billion in interest free deposits.

The empowerment of knowledgeable financial regulators who can react promptly to emerging problems is crucial, rather than more and more rules and oversight bodies. In Australia the mid 1990s Wallis Committee and the Government response allowed for a much clearer, more accountable regulatory structure. Australian banks raised considerable equity capital and raised it early in this crisis.

We believe that an objective reader of the financial statements of Bear Sterns and Lehman Brothers in 2008 or 2009 would have readily concluded that these entities had leveraged up materially over the decade in non liquid, hard to value assets. A focused, empowered regulator should have insisted upon more and better capital, as well as strengthened liquidity. We underestimated the reluctance on the part of such financially weaker institutions to raise additional capital (possibly because of their mistaken concern about diluting management equity) and the failure of regulators to insist upon extra capital early enough was a major contributor to the cascading crisis [billions of dollars of additional fiscal and monetary stimulus was required because the obvious systemic risks of undercapitalised financial counterparties were not addressed early enough]. Similarly, the only way in which Fannie Mae and Freddie Mac could reach effective leverage ratios of well above 100x, along with obvious liquidity/duration mismatches was because of poor Government oversight, regulation that was not independent of Congress and implied Government guarantees.

Market participants were aghast that erstwhile conservative institutions such as Bank of Scotland and RBS not only aggressively chased very highly leveraged private equity funding but decided to hold passive equity 'stub' investments in these transactions.

Relatively straightforward capital, liquidity and structural improvements by US, European and other international regulators can go a long way to reducing the systemic risks of major financial institutions. Lower leverage and lower peak profitability metrics are a small cost. Current proposals include some sensible initiatives. Aspects will inevitably be opposed and even the major the Australian banks are fighting some of the currently proposed global banking changes. Unlike the strongest US banks, well under 100% of their loan assets are covered by deposits, Australian mortgage assets are usually retained on Balance Sheet and dependence on foreign wholesale funding is much higher.

Many Governments remain preoccupied with short term economic growth and this has increasing danger for longer term financial stability in a world where capital flows are global and often rapid, and medium term projects like sustainable urban renewal which may yield meaningful societal benefit are deferred in favour of populist sugar hits.

Some significant political and regulatory risks remain very real. They are complex, difficult, global and will not go away in the foreseeable future. Our companies recognise that economic strength is a significant advanage in this environment. Usually this strength has been built over decades or in the case of the internet companies, eBay and Google, it is reflected in their combined US$30 billion cash on balance sheet.

For the foreseeable future and at current currency levels (well above long term averages) and in current markets (where Australia's principal commodity exports sell at multiples of their costs of production) we won't change our unhedged currency position. The global risks relating to sovereign debts and unwinding of stimulus, for example, are only now emerging.

We missed the opportunity to hedge the AUD when we looked closely at doing so in early calendar 2009 and hence our currency position has adversely impacted results from March to early 2010. By the time that we properly recognised factors such as the impact of China's stimulus and other forces upon commodity markets, the AUD had already appreciated above long term averages.

Australia's increasing aggregate level of foreign borrowings, balance of trade/ payments deficits despite high terms of trade and the likelihood of international interest rates 'normalising' somewhat (thereby reducing the attractiveness of the 'carry' trades) are factors we consider in adopting our long term position. The crisis has increased Australia's underlying structural twin deficits. The Australian Government's response to the Henry Review should be watched closely, as should Government policies elsewhere in the world as the price of a currency is an exchange of one for another. Hard policy decisions are required in many countries. Given their preoccupation with short term popularity, the choices confronting Governments around the World are more difficult than those confronting almost all of our companies.

Policy decisions by the US over decades show how a country's competitive advantages can be damaged by many poor choices but many remain. Perhaps this crisis will provoke some positive policy responses, and the US might use the serviceability benefits of currently low interest rates to improve its structural fiscal position. Over extended periods, smaller countries do not have the same flexibility as the US and are forced to deal with the deleveraging required. Individual country crises should be expected, and will likely cause initial flows to the USD, but also further increase pressure on the US to repair itself.

MFF continues to have exposures to currencies all around the globe with our companies also having significant and growing earnings from emerging markets. Switzerland is about the only developed country with surpluses at the Government, trade and payments balance levels, significant structural flows from earnings on overseas investments and attractive taxation rates to attract high value business operations. We believe that Nestlé has become a better company over the years as it has to increase its global earnings sufficiently to overcome the 'drag' of currency appreciation. We have kept our large Nestlé position entirely unhedged notwithstanding the AUD rise against most currencies and the efforts of the Swiss National Bank to attempt to prevent the CHF rising too far.

FINAL COMMENTS

Despite news cycles and political spin, we have been living in a period of unprecedented and broadly rising prosperity and relative peace. Millions are being lifted out of poverty and middle classes are growing.

Visitors to the United States and many other countries around the world should be amazed by the lack of social unrest and crime despite recently rising unemployment. On average, capitalism and freedom are winning, and people are getting on with living and providing for themselves and their families. The disciplines of the market mean that countries are working actively to attract capital and knowledge investments, to trade and improve their average standards of living. Advances in one country move rapidly elsewhere (our companies roll out new technologies and new products in 50 or more countries concurrently). The internet makes it easier for citizens to see how the rest of the world lives. Capital moves away from riskier markets and hence positive economic reforms generally occur, over time.

Investor expectations are low in the developed world, although many of the emerging benefits from the fall of the European Wall and the opening up of China are less than 20 years old.

The crisis has forced many investors to focus on short term risks and returns and overlook some outstanding companies whose advantages are 'hidden in plain sight'. If the world recovers strongly, these companies will do very well. If the world falls back into a double dip recession, they will do relatively better and replicate their satisfactory returns of the past few years. If the world 'muddles along', they will outstrip competition and strengthen their competitive advantages, whilst continuing to earn billions of dollars annually in cashflows and profits. The Australian Dollar is strong and buys more Euros, Dollars and Pounds than it has for decades.

We expect that the world will continue to provide interesting investing opportunities for global investors.

Chris Mackay

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25 February 2010

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