<u>Martin Raymond Real Return Fund</u> – December 2003 monthly report

Dear Unitholders,

This is the first monthly report for the Fund. Since its inception on 1st November, the fund has gained 0.37%, or 0.75% if we adjust for interest on undrawn capital. The fund owns securities in seven companies. Unfortunately, three of these positions are very small, but I am hoping to increase them if stock can be bought at the right price.

The four main holdings are:

WorldCom bonds. (5.2% of the fund) The background to WorldCom's collapse in mid-2002 is well known. Less well known is that WorldCom has now almost completed the bankruptcy process and in the next three months it will emerge as a lowly-geared, very profitable blue-chip telecom company to be known as MCI. The existing WorldCom bonds will convert to MCI shares. Although exact numbers are not yet known, I expect that the current bond price values the new shares at around 3-4x EBITDA, less than book value and a single digit P/E.

At worst, MCI is fairly priced relative to other telecom companies; more likely it is quite cheap. I expect the valuation gap between MCI and its peers to close after its shares relist. I am encouraged by the fact that MCI has enacted by-laws that (especially for an American company) are very shareholder friendly. I also like the fact that the CEO will be granted $US12m of free shares that will be priced on the first day's trading, ensuring that he has no incentive whatsoever to talk up the share price before relisting.

Village Roadshow, (5.2% of the fund) is another company with a reputation for poor accounting and lousy corporate governance. The fund has invested in Village's preference shares. The background to the preference shares is quite complex, but they are effectively a low-ranking fixed income security, trading at a 15% p.a. yield, and repayable in instalments over the next three years.

As you would expect in a security trading at such a high yield, there are a number of things that could go wrong between now and repayment of the shares, but we have two big things going for us. One is that Village has a very strong balance sheet, and three highly cash generative businesses. The other is that Village's proposal to buy back its preference shares transfers over $100m in value to the company's controlling shareholders. The company has the ability to repay us, and it is very much in management's interest to do so.

Australian Magnesium Corp (3.4% of the fund) was one of Australia's more spectacular disasters of 2003. The company had hoped to develop a major magnesium deposit in Queensland, but cost over-runs caused development work to stop. The company is now left with hundreds of millions of dollars of debt, a half completed project, and no means with which to repay its debt, or to complete the project. The shares are therefore highly speculative, and could easily go to zero during 2004.

The fund has however bought a special class of share, Distribution Entitlement Securities (“DES”), which have a minimum payment of 6.4 cents per share in 2004 guaranteed by the Queensland government, as well as conversion into ordinary shares. These DES currently trade at 7.9 cents, meaning that they provide an entry to the ordinary shares at around 1.7 cents. This compares to the 7.5 cents at which the ordinary shares trade.

You could argue that this type of investing represents a variation of the “greater fool” type of investing (which it is) but there are reasons to believe that Australian Magnesium might survive, and if it does the potential upside is substantial. At worst our downside is about 0.8% of the fund.

HHG plc (2.3% of the fund) is the recent spin-off of AMP’s UK arm. AMP has an awful track record of losing vast amounts of money in the UK, and misleading shareholders about its UK operations. With this background, I thought HHG would start trading at an attractive price.

Before the listing it looked great. Net asset value is hard to pin down, but is probably over 60p per share, possibly a lot more. Over the next five to ten years, HHG will generate considerable free cash. Although there are still risks in HHG, these are well reflected in the current price below 40p.

Sadly for us, some of HHG’s value was destroyed by the company’s decision to sell one quarter of its equity at a knock-down price (30p) just before listing. This was great news for those who received the shares, but diluted several pence off the value per share for the rest of us. HHG’s CEO lied about this transaction to AMP shareholders and acted against the interests of his shareholders. This caused me to be more wary of HHG than I might otherwise have been.

I am treating HHG as a trading stock between 30p and 50p. Ideally, I would prefer the shares to go down so that we can buy more.

The portfolio at the end of December comprised 83% cash. This partly reflects the fact that cash had not yet been received from one unitholder, but also reflects my inability to find enough securities to buy.

As I have said many times in the past, if I cannot find things to buy at suitable prices, then I will hold cash. In a bullish market, it is to be expected that a fund following this strategy will have a very high cash weighting.

I am currently trying to buy five securities, including the three tiny holdings in the fund, and am cautiously optimistic of spending some money on some of these. I continue to work at finding new names to enter the portfolio.

Fred Woollard
6th January 2004

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