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MMC Contrarian Limited (MMA) Quarterly Investment update June 2004

In this, the second quarterly update we explain the structured and methodical approach we adopt when investing your capital – our investment process. There are also reports on two further contrarian opportunities – IOOF Holdings Limited (IFL) and Reinsurance Company of Australia Limited (ReAC).

A summary of MMA's investments at the end of June 2004 is set out on the next page. MMA's NTA per share before tax on unrealised gains has increased from 100.8 cents at 31st March 2004 to 105.4 cents as at 30 June 2004. The composition of the portfolio has not changed materially except for a substantial investment in the Gribbles Group Limited (GGL), a healthcare provider with interests in several diagnostic businesses in Australasia.

Your company's gross assets have increased in value by $9.2m over the three month period with 42.3% of the portfolio at 30 June 2004 invested in equities and hybrids compared with 37.6% at 31st March 2004. The investments comprising this concentrated equity portfolio have all risen in value during the three month period except for ReAC. Although this may be re assuring for both you and us it is important to realise that we aim to outperform over the long term and do not place undue emphasis on short term performance especially when investing in contrarian opportunities.

Your portfolio currently comprises a substantial amount of cash. This does not concern us as we do not feel compelled to invest your company's assets in the share market if suitable contrarian opportunities are not available. We are comfortable with holding a high level of cash or cash equivalents while we continue to seek suitable opportunities in what we consider to be a market with few value investment opportunities.

An unaudited summary of MMA investments at 31st March and 30th June 2004 is detailed below

Summary of Investments valued at market	31st March 2004 $000	% of portfolio	30 June 2004 $000	% of portfolio
Equities				
Burns Philp & Company Ltd (BPC)	18,065	9.0	18,117	8.6
PMP Limited (PMP)	16,854	8.4	19,329	9.2
Gribbles Group Limited (GGL)	–	–	8,145	3.9
Hunter Hall Global Value (HHV)	9,515	4.7	8,439	4.0
IOOF Holdings Limited (IFL)	7,394	3.7	9,836	4.7
Reinsurance Australia Corporation Ltd (RAC)	4,286	2.1	3,896	1.8
Other	4,398	2.1	5,963	2.8
	60,512	30.0	73,725	35.0
Hybrids				
ANZ Ltd 8_ % Preferred Securities (StEP)	10,140	5.0	10,160	4.8
Commonwealth Bank Pref shares (PERLS)	5,175	2.6	5,193	2.5
	15,315	7.6	15,353	7.3
Funds on deposit	126,000	62.4	121,869	57.8
Total capital employed	201,827	100.0	210,983	100.00
NTA per share before tax -cents	100.8		105.4	
MMA share price	93.0		97.0	
(Discount) Premium to NTA before tax-%	(8.4)		(8.7)	
NTA per share after tax- cents	100.2		103.7	
(Discount)Premium to NTA after tax-%	(7.7)		(6.9)	
MMA option price -cents	3.4		4.0	

The NTA at the time of listing was 98.1 cents.

<u>Investment process</u>

MMC has a structured and methodical approach to investing.

We believe that the stock market is not perfectly efficient in creating rational prices. MMC and HGL Limited have historically shown that if we consistently apply our **disciplined investment process** and apply these principals **over the long term**, we can out perform the market.

<u>Identification of contrarian opportunities:</u> We consistently monitor the market for contrarian opportunities (we refer you to our March 2004 quarterly update where we explain in our opinion what constitutes a 'contrarian investment'). These opportunities are identified by our investment team which now consists of five experienced executives who read the financial press, industry magazines, talk to intermediaries, screen companies and monitor share price movements on the ASX on a daily basis and keep their ears close to the ground for likely opportunities.

<u>Research</u>: After identifying a potential target we then commence appraisal of the company which includes:

- Researching and analysing the company's financials to assess likely future earnings and cash flow estimates and the strength of the business
- Visiting management and the operations to assess the company's commercial prospects
- Reviewing and monitoring announcements, brokers reports on the company, its industry or competitors or suppliers to obtain a better understanding of the company and then
- Verifying and cross checking our findings with as many independent sources as possible.

We also have a comprehensive list of criteria we assess when analysing a company and are attracted to companies that:

- are not capital intensive, are easily understood and produce an attractive level of 'free' cash flow
- generate high returns on capital employed
- have attractive investment fundamentals such as low price to earnings and cash flow multiples based on facts, rather than rosy perceptions of what may happen in the future and
- have management whose interests are aligned with shareholders who have a record of performance and integrity

Our investment process places a substantial weighting on the company's ability to generate high levels of 'free cash flow' and not just accounting profits and managements ability to run and achieve the company's strategic plans.

By putting all the above information together we gain an informed view of the factors that determine the company's value. When the investment team meets to discuss an opportunity they have a good idea of the company's prospects and are able to discuss and challenge each other to ensure it is an opportunity for MMA.

Portfolio Structure: The portfolio will be invested in a concentrated number of companies principally listed on the ASX which meet the criteria listed above. Most of these companies by nature are likely to be outside the top 50 ASX ranked companies. To date we have not invested more than 10% of the portfolio in any one opportunity.

Monitor: After an investment has been made the research process continues and often becomes more rigorous. We monitor every investment every working day with a critical eye and keep analysing and researching. We keep close contact with the company to ensure that everything is going as expected and that the company's management are implementing the strategies previously articulated.
Should any of the above criteria that led us to investing in the company change, or should the price in our view increase substantially and the shares became overvalued we would re-evaluate our position and may consider selling all or part of our holding.

The above summary provides you with some insight into our investment process. It requires rigour, focusing on value, investing in a concentrated portfolio with low investment turnover, patience and persistence.

IOOF Holdings Limited

Market capitalisation: $337m

IOOF is one of Australia's oldest remaining independent financial services institutions having been established as a mutual in 1846. The company listed on the ASX in December 2003 and now predominantly operates in the funds management industry which has experienced significant growth in recent years. A phenomenon which is set to continue given current population age dynamics and government mandated growth generated through the superannuation industry.

Much of this growth has been concentrated in retail master funds and platforms offering investors broad choice and access to a wide range of fund managers.

IOOF has positioned itself well in this regard by offering a range of platform and managed funds as well as having a substantial investment in the rapidly growing Perennial Investment Management Group. In addition, through the recently acquired AM Corporation, IOOF now is able to offer an extensive range of superannuation products.

At the time of writing IOOF was capitalised by the share market at around $337m. We estimate there to be surplus cash within IOOF of approximately $70m, implying a value of around $267m ($337-$70m) for the Brand and the continuing businesses encompassing AM Corporation, company owned financial planning groups, the master trusts and a substantial investment in Perennial Investment Management Groups. Total funds under management and administration should approximate between $15-16b as at end June 04.

When IOOF listed last December it was not well understood by the market. There were also a number of risks facing the company. It was looking for a new CEO, had recently expanded by acquiring AM Corporation and was still in the process of integrating this acquisition and was negotiating with the Perennial Investment Management team to ensure their long term commitment to the group.

After carrying out extensive research on IOOF shortly after it listed we concluded that the market had not recognised the full value of the Perennial Management Group and the potential benefits that the AM Corporation acquisition provided.

Other reasons for taking an initial large stake in the company and then subsequently increasing our holding include:

- Management, now led by former J.P. Morgan M.D Ron Dewhurst carry a wealth of industry experience particularly with regard to Ron Dewhurst who has a history and track record in growing and developing a large funds management business;
- The strong brand name recognition of IOOF and Perennial;
- Further potential to significantly increase funds under management in the Perennial group of companies;
- The opportunity to decrease the current cost to income ratio which is extremely high by industry standards and thereby improve profitability significantly;
- Potential to consistently grow and pay fully franked dividends to shareholders;

- The opportunity to either utilise the company's significant cash reserves in accretive add-on acquisitions or to return capital to shareholders;
- The company's vulnerability to takeover at what would need to be a very generous price given IOOF's brand, market position and the ability to remove significant cost duplication;
- The highly scalable and non capital intensive nature of the business and its ability to thereby generate strong free cash flows;
- The identifiable growth profile of the company evidenced by the large growth in funds under management and administration.

IOOF also, as is the case with any other investment, carries a number of risks, including:

- Competitive influences which may impact on funds growth and margins;
- Vulnerability to Perennial should its investment returns under perform for a protracted period of time;
- Potential integration difficulties with respect to AM Corporation;
- Failure to deploy cash reserves in an earnings accretive manner;
- Negative share-market conditions which could impact funds under management and administration growth;
- Failure to significantly reduce the cost to income ratio.

While building a stake in the company we noticed that there were an abnormal number of sellers in the market who had been long term policy holders who were now able to capitalise on the liquidity of their investment. This allowed us to acquire a decent size stake in the company. At the time of writing the company share price has reached an all time high and your investment has appreciated substantially over this short period.

Reinsurance Australia Corporation Limited

Market capitalisation: $109m

For those unfamiliar with the actual business of reinsuring we provide a simple outline as follows.

In each type of insurance there are risks which because of their size or nature an insurance company cannot afford to bare on its own; the jumbo jet is one of the best examples. Generally an insurance company will in this case insure the whole risk and then lay off a large amount to other reinsurance companies keeping only what it can bare.

A reinsurance transaction thereby eventuates where the insurance company agrees to cede and a reinsurer agrees to accept a share of risk upon certain terms as set out in an agreement. In essence it is similar to a bookmaker at the horse races laying off a large bet to a number of other bookmaking colleagues who share the risk in the event the horse with high odds wins.

Reinsurance Australian Corporation Limited (ReAC) listed on the Australian Stock Exchange in 1993 to provide a reinsurance portfolio of risk and catastrophe business for the Property, Marine and Aviation industries. The company expanded into the international markets opening offices in Europe, America and Asia while its capital base had grown to $515m by 1998.

In 1999 ReAC suffered huge underwriting losses, resulting from catastrophic events in the insurance industry and bad underwriting decisions due to poor management within the company which put its total capital base at risk. This led to a dramatic plunge in ReAC's share price from $5.00 to a low of 3 cents – putting the company at risk of total collapse. As a result ReAC ceased underwriting and engaged in a self managed run off. This entailed trying to settle its outstanding claims (some of which were already known while others had not eventuated because of the length of the reinsurance contracts) against the assets it held which were predominantly cash, fixed interest securities, and money due from third parties.

On 2nd May 2000 APRA appointed an inspector to oversee ReAC's run off process as the company had not maintained its solvency requirements.
The run off process which is now almost complete involved outstanding claims being reduced by over $1.4 billion through commutation or payment over a period of 5 years to December 2003. Approximately 77% of client relationships were commuted involving the cancellation of over 92% of the reinsurance contracts outstanding at the time ReAC engaged in the self managed run off.

A milestone for the company was reached when ReAC announced on the 22nd October 2003 that they had settled the majority of its exposure to the film indemnity business which had the effect of increasing its net assets by $37m (18 cents per share) to $75m (38 cents per share).

This settlement substantially reduced the risk profile of ReAC and created the possibility of rehabilitation of the group as an insurer.

MMC acquired a 5% holding in ReAC in January 2004. There are a number of reasons we believe this to be an attractive investment which include:

- ReAC shares were trading just above the company's NTA. However, at the time MMA acquired majority of its shareholding ReAC had two major unrecorded intangible assets that were not being reflected in the market value of the company. These intangible assets were $150m of tax losses and $66m of franking credits
- The company had a board which was pro-active with strong shareholder representation with an incentive to rejuvenate the company
- ReAC had replaced its senior management with a professional and experienced management team who over the past five years successfully managed the very difficult task of commuting the company's liabilities while at the same time keeping the liquidators at bay. We formed the view at the time of making our investment that ReAC would utilise its "run off" expertise in other areas and this was confirmed at the recent AGM in May 2004 where the chairman acknowledged that the company would be pursuing consulting activities to assist other reinsurers in the area of managing run offs under the stewardship of Mark Moyes
- As a result of the settlement of majority of company's exposure to the film indemnity business ReAC's capital base had grown to 7.8 times the minimum level required by APRA prudential standards. This allows ReAC to pursue strategic initiatives beyond run off such as entering the general insurance market. In this regard the company announced at the AGM in May 2004 that Nick Kirk who came from Promina had been appointed CEO of general insurance and was highly regarded in developing speciality insurance lines
- ReAC still held $50m reserved for outstanding claims at December 2003. However, only a small number of the contracts outstanding were exposed to unexpired risk. In our view there could be further possible write backs which would result in an increase in the company's NTA.

Our research and assessment of ReAC therefore confirmed that an investment in ReAC provided limited downside with substantial upside. This is a true contrarian investment where the odds were favourable as ReAC was unloved, not well understood and undervalued when the unrecorded tax assets and potential future income from run off consulting services and re-entering the insurance market are taken into account.

Cash and hybrid securities

At the end of June 2004 MMA held investments of $122m in cash deposits and a further $15m in hybrid securities.

Approximately $52m is held on short term deposit with the Adelaide Bank, $20m with Westpac, $50m held on deposit at call with the ANZ Bank and we have invested $15m in ANZ StEPS and Commonwealth Bank Preference shares (PERLS). The investment in hybrid securities generally provides an additional margin over cash held on deposit and we have one full time executive managing this part of the portfolio.

While MMA holds substantial amounts of cash we continuously look for opportunities to improve returns.

The next quarterly investment update will be issued in October 2004.

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