The Conscious Investor® Fund: Safety and Performance

The Conscious Investor® Fund is a wholesale fund focussed on finding long-term value through investing in quality businesses. Its rigorous approach is scientific, conservative and fresh. It invests in Australian and overseas listed securities as well as select private companies.

When measuring safety and performance there are basically four ways: growth in earnings and dividends per share well above inflation for the companies in the fund, improvement in the economic moats of the companies, natural diversity of the portfolio, and overall change in the unit price allowing for the distribution of dividends. The first two also have the benefit of acting as guides for the Capital Allocation Team to increase the success of the fund. The third method is an outcome of carefully looking for companies with the highest long-term profit potential. The last method, although the most quoted by the general press, is the least useful and is often misleading, particularly over the short to medium term. For this reason, instead of unit prices, we prefer to focus on the increase in dollar value of an actual benchmark portfolio.

Contents

Measuring Safety and Performance: Background

As explained in the Information Memorandum, wherever possible the Capital Allocation Team follows the investing principles of Warren Buffett as it builds the Fund. This is why our main goal, quite simply, is to find safe investments that have a high likelihood of growing their earnings per share and dividends per share over a five- to ten-year period. As a minimum target, we expect this growth to comfortably exceed inflation.

As Warren Buffett said,

> Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value. Though it's seldom recognized, this is the exact approach that has produced the [extraordinary] gains for Berkshire [Hathaway] shareholders.[1]

The second way we measure safety and performance of the Fund is whether the management of the companies in the Fund are strengthening the economic moats for their products and services. Also we ask if we can be confident there will continue to be need for their products and services in five to ten years. Although these are more subjective, over time they give confidence that earnings and dividends will continue to grow.

Teaminvest Private Another initiative for safety and performance is that the Fund has been approved to invest in Teaminvest Private companies. Teaminvest Private is a membership organisation with a thorough systematic process of evaluating private companies to partner with.

When all this is done, we look whether the portfolio is well diversified and whether there has been healthy growth in the dollar value of the holdings of Fund members as measured by the growth of a benchmark portfolio.

Why You Should Not Pay Too Much Attention to the Unit Price

Many investors make their decisions based on historical performance of the unit price, a dangerous practice. No honest manager can promise matching past returns, consistent outperformance, or investing without downside risk potential. Markets are forward-looking, not backward-looking, and you cannot buy past returns. Selling past performance is the way money managers play to your anxiety. We believe this isn't in your best interests.

In fact, investors in managed funds actually do considerably worse than the average performance of funds. Too many chase performance by continually switching to the current "hot" fund and actually fail to achieve even average levels.[2]

Another reason not to pay much attention to the movement of the unit price is that often you get widely differing results depending on the specific days the unit prices are recorded. Measuring the growth between two dates can change markedly depending on the actual dates.

You can also get widely differing results depending on the order that you make deposits into a fund even though the overall growth in the unit price may be the same. For example, suppose an investor invests $1 million at the start of Year 1 and another $1 million at the start of Year 2. Imagine two scenarios: In Scenario #1 the Fund is flat in Year 1 and returns 20% in Year 2. In Scenario #2 the Fund returns 20% in Year 1 and is flat in Year 2.

This means that in both Scenarios the fund averages 9.54% per year over two years.

---

[1] Letter to Shareholders, 1996

[2] This is seen in studies such as *Buy High, Sell Low: Timing Errors in Mutual Fund Allocations* by Stephen Nesbitt (The Journal of Portfolio Management, Fall 1995, Vol. 22, No. 1: pp. 57-60). Also see the annual reports by Dalbar with the same conclusion.

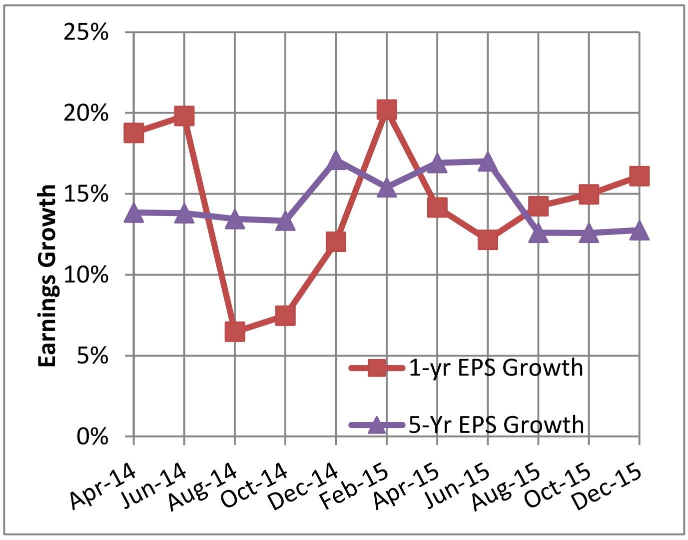
Yet, the returns from both scenarios are quite different. In Scenario #1, the total value of the investment after two years is $2.4 million while in Scenario #2 it is only $2.2 million. In other words, Scenario #1 resulted in a profit of $400 thousand, twice the profit of Scenario #2 which is $200 thousand.

1. Growth in Earnings and Dividends per Share

For Fund performance we want earnings per share (EPS) of the chosen companies to be growing each year. A guide whether this is likely to take place is by looking at the average growth of EPS over their recent history. So it makes sense to search for companies that are likely to grow their EPS in the future amongst companies that have already achieved this in the past.

For this reason, we like to track the average growth rate of EPS for the companies in the Fund. Similarly, we like to track the average dividend yield of these companies.

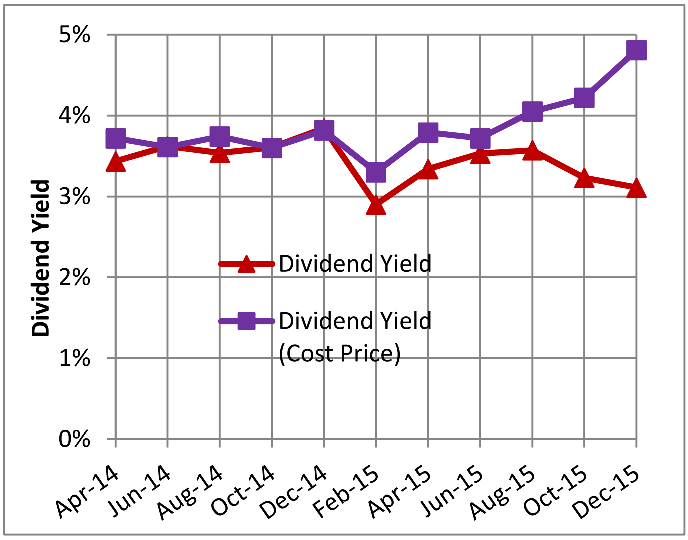
The next chart shows the history of the average growth of EPS for the holdings in the Fund over the previous one year and five year periods. The growth rates of the individual companies are weighted according to their proportion within the Fund. Everything is recalculated at the end of each two months. Notice that the rates are well above the level of inflation. Our key goal is to choose those companies with strong historical growth of earnings per share and with the highest likelihood of this growth continuing in the future as it has in the past.



Despite it seeming obvious that we would want to choose companies with growing earnings and EPS, it comes as a surprise to many that such companies are in the minority. For instance, over the past 12 months, only 30 percent of companies on the ASX actually made a profit and less than half of those had EPS that was growing for the previous 5 years.

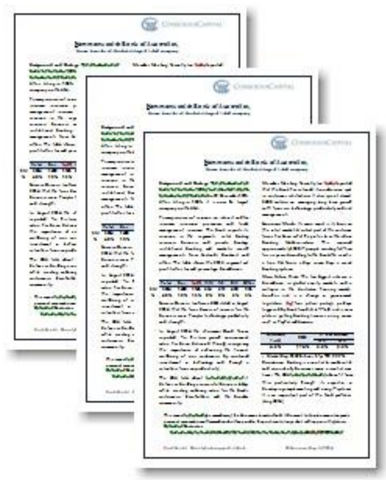
Dividends are also an important part of investment in Australian companies. The next chart shows the history of the average dividend yields for the holdings in the Fund.

In the first case the calculations use the dividend yield of each company based on their prices at the time of the calculation, which is the usual method. However, some investors like to see the dividend yield based on the cost price. For this reason, in the second case dividend yield is calculated using the cost price of the individual companies. In both cases, the yields of the individual companies are weighted according to their proportion within the Fund. Everything is recalculated at the end of each two months.



2. Improvement in the Economic Moats of the Companies

As part of its on-going scrutiny of companies, the Capital Allocation Team is continually discussing new opportunities and reviewing the companies already in the Fund's portfolio with a careful focus on economic moats. Strong and durable economic moats are vitally important in gaining confidence that a company will continue to grow its earnings and sales in the future.



Although most of these discussions are internal, the Capital Allocation Team publishes concentrated one-page summaries for members of the Fund for some of the key companies in the Fund. These summaries look at companies under the topics: Background and Strategy, Success Drivers, Member Meetings with Management, Economic Moats, Main Future Risks, Company Performance and Conclusion.

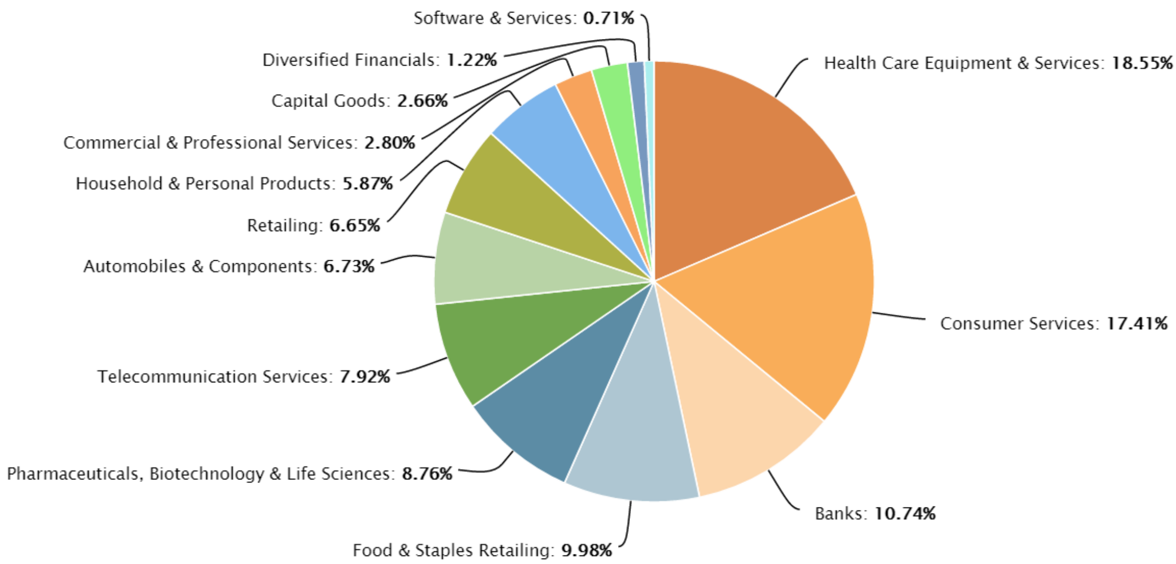
3. Natural Diversity of the Portfolio

Although investors and analysts talk about the importance of diversity, there is a lot misunderstanding regarding this concept. In the pursuit of diversity most investors and money managers end up investing in mediocre companies in order to achieve variety in the holdings. But, as Warren Buffett wrote:

> I cannot understand why an investor … elects to put money into a business that is his 20th favorite [to achieve diversity] rather than simply adding that money to his top choices - the businesses he understands best and that present the least risk, along with the greatest profit potential. In the words of the prophet Mae West: "Too much of a good thing can be wonderful."[3]

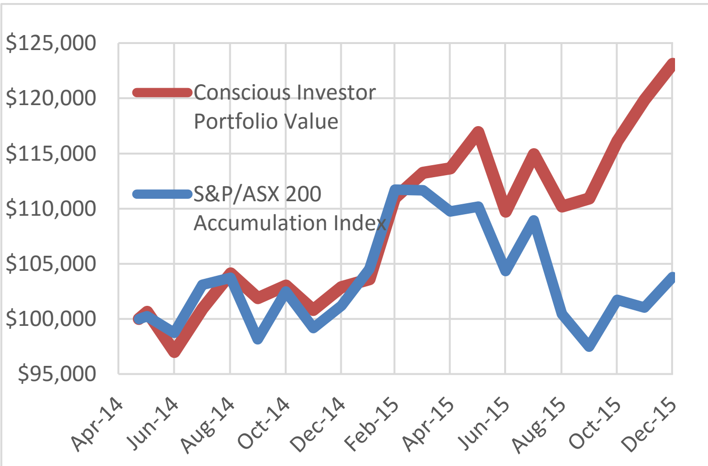
[3] Letter to Shareholders, 1993

As the next chart shows, the portfolio of the Fund is well diversified. But this occurred as a natural outcome of continually scouring the market over all sectors for the best long-term investments, with particular emphasis on the companies already in the portfolio. Furthermore, recently this searching was extended to the US market so that currently 4.5 percent of the portfolio consist of companies with headquarters in the US. Currently the Fund also had approximately 3.3 percent in cash consisting of both Australian and US dollars.



4. Growth of a Benchmark Portfolio

Instead of talking about the growth of the unit price, it makes more sense to talk about the actual growth of wealth of a typical portfolio. With this in mind, an actual portfolio (Price Value Trust) was started on 22 May 2014 as a benchmark with an investment of $100,000. The adjacent chart shows the growth of the dollar value of this portfolio since that time after success, data and transaction fees assuming dividends are reinvested.



Comparison: Comparison of Conscious Investor Fund and the S&P / ASX 200 Accumulation Index: From 22 May 2014 to 31 December 2015

	Growth of $100,000	Total Return	Average Annual Return
Fund	$123,120.31	23.12%	13.81%
Index	$103,803.60	3.80%	2.35%

Conscious Investor® and the Teaminvest Methodology

The Capital Allocation Team of the Conscious Investor Fund continually monitors world share markets as well as selected private companies. For details of how this is done, please see the Information Memorandum.

Apart from a massive amount of number crunching using Conscious Investor to select the best companies, there is also extensive business analysis in the following areas:

- How does the company make money? What is the business of the company? Who are its customers? Are we confident that there will be need for their products and services in five to ten years?
- Investments should be like castles with deep moats: What are unique features of the business that separate it from its competitors? These "economic moats" are scored in terms of depth and durability.
- Risks need to be identified: All businesses face risks that could weaken the continuing success of their operations. These risks are identified and are scored according to the likelihood of their occurring over the next economic cycle and their potential damage if they do.
- Is management honest, open and rational? As part of examining the business, evaluation is made whether or not it is believed that the board and senior management are acting honestly, rationally and in the best interests of shareholders. Specific areas that are looked at include the number and type of related party transactions and the remuneration structure for the CEO and senior management. The Capital Allocation Team scores remuneration in terms of clarity, alignment and quantum. Another question is whether the board and senior management have significant holdings in the company with particular focus on whether they were bought with their own money.

Weighing Machine, Not a Voting Machine

Recently Warren Buffett wrote[4]: "As Ben Graham said many decades ago: 'In the short-term the market is a voting machine; in the long-run it acts as a weighing machine.'" Overtime, the share market "weighs" the real value of any investments. The Capital Allocation Team is confident that it has the skills, the methods and the temperament to weigh and find investments for the Fund that will provide long-term safety and value to its members.

Why We Started the Fund

A few years ago, members of Teaminvest began to ask: "What happens to my investments if I'm no longer able to run them or I no longer want to run them?"

In response to this question, after a lot of thought we decided the best solution was to start a fund. The result is the Conscious Investor Fund. We thought that Members of TeamInvest might like to put some of their capital into the Fund as a prudent step towards preparing for the time when they no longer want to, or are able to, manage all their assets.

[4] Letter to Shareholders, 2015

We also thought that the Fund could give our members increased peace of mind. Instead of having the responsibility of all their capital with a single fund manager (namely, themselves), the fund would allow them to invest some of their capital into a fund with the same Teaminvest principles that they already understood and trusted.

Once the Fund was started, investors who were not members of Teaminvest heard about it and wanted to invest in it. So we decided to open the Fund to all wholesale investors.

The Capital Allocation Team prepared this report for members and others interested in the Conscious Investor® Fund. It does not take into account anyone's personal circumstances. Remember, what happened in the past is not always what will happen in the future.

If you would like to invest in the Fund or have any questions, please contact us at enquiries@consciouscapital.com.au or

Conscious Capital Limited AFSL 427 216 Level 10, 53 Walker Street, North Sydney 2060, ph 02 9954 4017.