Conscious Capital: Letter to Members

Six months: July 2013 to December 2013

Your Capital Allocation Team has been busy over the past six months looking for secure investments for your money. Our role has three parts:

- Identifying great businesses in which we have confidence that earnings will continue to grow
- Ensuring that management is trustworthy and acting in the best interests of shareholders
- Buying at a price that offers us a reasonable return with safety

The first point means that the Team continually scans the market looking for companies with, at least, high return on equity, low debt, consistent growth in earnings and sales, and deep economic moats. (See the later section: Conscious Investor® and the Teaminvest Methodology.)

Regarding the second point, paraphrasing Warren Buffett, the first priority is you want management to be honest, intelligent and hard-working. If they don't have the first quality, you definitely don't want them to have the second and third – as they will simply enrich themselves at your expense. Philip Fisher made a similar point by always insisting that management had unquestionable integrity before he would invest in the company.

This is why the Capital Allocation Team tries to assess the board and management before buying any shares in a company.

In many ways over the past six months finding great businesses with good management was the easiest part of this process. Because of the overall market levels, it was harder to find such businesses at prices that would most likely give attractive returns over the long term. But your Capital Allocation Team continues to closely monitor great businesses looking for every opportunity to take advantage of price dips.

However, in general we prefer to sit on the sidelines with a fair amount of cash rather than put money into shares when we don't have confidence they will give reasonable returns. Furthermore, as Warren Buffett said, when you have a buffer of cash "during the episodes of financial chaos that occasionally erupt in our economy, we will be equipped both financially and emotionally to play offense."

Main Investments

The following is a description of the five companies that have the largest allocation of capital. The standout investment over the six months from July to December was Domino's Pizza, particularly after its purchase of 75 percent of Dominos in Japan. We also include a discussion of the company at the other end of the scale, Forge Group. It wrote down the acquisition of two power stations by $127 million which caused a sharp drop in its share price.

Domino’s Pizza

Domino's Pizza Enterprises Limited (Symbol: DMP) is the largest pizza chain in Australia in terms of both network store numbers and network sales. It is the fifth largest Quick Service Restaurant chain in Australia by network store number (behind Subway, McDonald’s, KFC and Red Rooster). DMP holds the exclusive master franchise rights for the Domino's brand and network in Australia, New Zealand, France, Belgium, the Netherlands and the Principality of Monaco. In August it purchased 75 percent of the Domino’s franchise in Japan consisting of 216 corporate stores and 48 franchise stores. With the Japanese acquisition the company has more than 1200 stores (approximately 20% corporate stores and 80% franchised stores) employing around 21,000 people and making more than 60 million pizzas a year.

Despite this activity and size, its success has come from it being more a digital retail company than a pizza company. In Australia over 50 percent of orders are done online, half of which are from mobile phones. Online ordering is a huge cost efficiency for the company since the order goes straight into the production system without requiring the time of any staff. The stated goal of the company is that 80 percent of ordering will be online by 2016.

The CEO is Don Meij who commenced his career as a delivery driver for Silvio’s Dial-a-Pizza in 1987 becoming a store manager in 1989. So long as consumers like the convenience of having pizzas of reasonable quality delivered to their homes, he will continue to expand the business. Shares were bought in the range $10.20 to $11.32. At the end of December the price was $16.17.

ARB Corporation

The origins of ARB Corporation (Symbol: ARP) go back to 1975, when company founder, Tony Brown, was inspired by a 4WD trip through the top end of Australia. Back in the family garage he thought that he could build better bull bars and roof racks than were available at the time. Today ARB is a quality Australian company that manufactures accessories for 4X4 and light-commercial vehicles. Although most of the sales come from Australia (89.4%), 9.9% come from the USA (where the company has an office), and 0.7% from Thailand (where it has a manufacturing facility). It has distributors in over 100 countries.

The company has 46 ARB branded stores across Australia, 18 are company owned and 28 are independent licensed stores.

The Chairman, Roger Brown, and MD, Andrew Brown, impressed us with their simple remuneration structure and dedication to creating shareholder value. For example, the senior executives are paid fixed salaries without any bonus structures. As stated in the annual report: “The remuneration policy is not directly related to Company performance. The Board considers a policy based on short-term returns may not be beneficial to the long-term creation of wealth by the Company for shareholders.” We agree.

The three executive directors, Roger Brown, Andrew Brown and John Forsyth, all hold large numbers of shares (respectively, 8,150,994, 8,150,994 and 2,214,667) so they have a lot of skin in the game. On a year by year basis, they benefit from dividends paid by the company. We do too, as investors or part-owners. Also, for the past 15 years every three or four years the company has paid a generous special dividend. The two most recent special dividends were in 2005 and 2009. Shares were bought in the range $11.02 to $12.86. At the end of December the price was $11.71.

Monadelphous Group

Monadelphous Group Limited (Symbol: MND) started as a service company to the mining industry in Western Australia. Now it provides extensive engineering construction, maintenance and industrial services to the resources, energy and infrastructure sectors across Australia with some activity in China and New Zealand.

Its EPS performance over the past ten years has been remarkable with an average growth of 30.50 percent per year with return on equity over 50 percent. Because some of its revenues come from mining services, its price has been pushed down. However, this now means that we now benefit from a dividend yield exceeding 7.0 percent.

Monadelphous provides its services through three operational areas:

- Engineering Construction: Large-scale, multidisciplinary project management and construction services in addition to delivering electrical and instrumentation installation and construction services (67%).

- Maintenance and Industrial Services: Planning, management and execution of multidisciplinary maintenance services, shutdowns and minor capital works (26%).

- Infrastructure: Multidisciplinary services in engineering construction, operations and maintenance to diverse markets. (Skystar Airport Services used to be a part of the infrastructure section but in October Monadelphous announced its sale to Menzies which will result in a one-off profit of $10 million.)

We have always been impressed by the understanding and vision of senior management regarding the company and what drives shareholder value. Shares were purchased in the range $15.51 to $24.12. At the end of December their price was $18.58.

Cochlear

Cochlear Limited (Symbol: COH) is the global leader in implantable hearing solutions. It has a global team of more than 2,700 people operating in over 100 countries. Over 30 years it has helped hundreds of thousands of people.

Recently the company has been putting more attention on the fact that hearing loss is a major public health problem. They maintain that hearing is critically important in developing and maintaining optimal cognitive, physical and social function across all ages.

The main obstacle for the profitability of Cochlear is getting approval from the various health regulatory bodies around the world. As an example, in November the company announced that an advisory committee to the US Food and Drug Administration (FDA) had voted favourably on the Cochlear Nucleus® Hybrid L24 Cochlear Implant System. However, this is only a single step and does not bind the FDA to granting approval. This system is the first of its kind designed for the treatment of adults with severe to profound sensorineural hearing loss in the high frequencies and normal hearing to only mild hearing loss in the low frequencies, often referred to as “sky-slope” hearing loss.

Another of Cochlear’s products is the BAHA or Bone-anchored hearing aid range. Key new products are the Nucleus 6, Hybrid (still requires Pre-Market Approval, PMA), BAHA 4, BAHA Attract and acoustic implants.

The MD, Chris Roberts, and company is open to discussing its plans and initiatives. The Company has a deep moat through its established brand name, distribution network and intellectual property (licenses and patents).

There are three major future risks. First, it is possible in the future that a new technology may make the Cochlear implants obsolete. Second, the delays with regulatory approvals may allow its competitors to catch up or move ahead. Third, competition may forces margins to be reduced.

Overall Cochlear has a suite of new and revised products the company hopes will build momentum in 2014 with strong results in 2015. Shares in Cochlear were bought in the range $57.76 to $59.68. On December 31 the price was $58.92.

Woolworths

No matter what the state of the economy, we always need food. Woolworths (Symbol: WOW) is Australia's largest player in supermarkets with 1063 stores across Australia and NZ. It also has operations in liquor, petrol/convenience stores, hardware (Masters), discount department stores (BIG W) and hotels and gaming.

Woolworths' current business growth plan is built on four key strategic priorities.

1. Extend leadership in food and liquor

2. Act on its portfolio to maximise shareholder value

3. Maintain its track record of building new growth businesses

4. Put in place the enablers for new growth

Recently it entered the hardware sector with 31 Masters Stores trading with 18 planned for FY14. This is a long-term proposition to add profit to the company. They hope for around 90 stores by the end of FY16.

The company says that there has been a positive response from customers on range and price. The company is putting increasing emphasis on online sales and is on track to have $1 billion of sales by FY14. It recently purchased EziBuy, a leading direct retailer of apparel and homewares in Australia and New Zealand.

In 2013 WOW opened 34 supermarkets in Australia, 6 BIG W’s, 16 Masters, 16 Dan Murphy’s and a net additional 14 BWS stores. Every week the company serves an average of 28.4 million customers.

One ongoing problem is the possibility of harsh restrictions placed on the company by the ACCC. Another risk is that in its race for growth compared to Coles that it makes a large foolish acquisition. Finally Masters may end up as a money sink and not generate the returns hoped for.

The Company is attractive as an investment because of its high ROE, sustained growth, and the essential nature (that is, food) of most of its sales. Shares in Woolworth's were bought in the range $33.57 to $33.63. At the end of December their price was $33.85.

Forge Group

Forge Group (Symbol: FGE) provides engineering, procurement, and construction services, as well as asset management solutions to resources, energy, and public utility sectors in Australia, Asia, West Africa, and New Zealand.

At the annual meeting on 24 October 2013 the Chairman painted a positive picture for the future of Forge with no indication that there were any difficulties. Just over a week later on 4 November, Forge went into a trading halt. When it started trading again on 28 November the company stated that basically they had failed to properly evaluate two power stations (the Diamantina Power Station and the West Angelas Power Station) that were part of a recent acquisition. As a result the power stations were to be written down by $127 million. They also anticipate a EBITDA loss of between $85 to $95 million for FY14.

Over the period of the trading halt the price had dropped from $4.18 to under 50 cents. Since then it has risen to around $1.30 to $1.50. Unfortunately before the trading halt we increased our holding by 20,000 shares. Overall we now hold 31,500 shares giving us a loss of approximately $106,000. On the positive side, the company stated that it still has a contracted order book exceeding $1.8 billion of which $900 million is expected to be delivered in FY14. It also has a financing agreement with ANZ.

Because the problem was made public so close to the Annual Meeting, it is likely that there will be a class action against the company. If so, we would anticipate taking part in such an action.

Ten Largest Holdings

The following table shows the average eps growth over the past five years, cost price and the total value at the end of December as measured by the market value and dividends over the period July to December of the ten largest holdings in the Fund.

Ten Largest Holdings in Fund

Shares	Name	EPS Growth pa (5 yrs)	Value on 1 July 2013(1)	Total Value on 31 December 2013(2)
21,646	Domino Pizza Enterpr	19.20%	$234,125	$350,016
26,790	ARB Corporation	15.06%	$304,574	$313,711
15,565	Monadelphous Group	19.15%	$248,533	$289,509
3,550	Cochlear Limited	3.79%	$206,327	$209,166
5,974	Woolworths Limited	8.99%	$194,666	$202,220
61,285	Metcash Limited	4.59%	$203,531	$193,661
14,000	Mineral Resources.	25.01%	$130,161	$166,180
4,644	Westpac Banking Corp	6.65%	$131,867	$150,373
3,000	Flight Centre Travel	15.30%	$137,220	$142,650
40,051	Mermaid Marine	17.16%	$137,864	$136,173
	Others		$1,507,419	$1,427,577
	Total		$3,436,288	$3,581,236

(1) The Value assumes that the shares were owned on 1 July 2013

(2) The Total Value column includes receipts from dividends over the 6 months Jul - Dec 2013

War Chest

As at the end of 2013 we held 29.0 percent of our portfolio in cash. While the returns on cash are low, we view this as a war chest we have ready to deploy the moment Mr Market falls out of love with one of our favourite companies – as we can expect to happen from time to time. While this may cause other investors to panic, we're overjoyed when we see great businesses sold down to bargain prices. Your Capital Investment Team stands ready to act quickly to deploy cash when Mr Market obliges.

Conscious Investor® and the Teaminvest Methodology

The investment process for the Fund consists of four steps: Filtering using Conscious Investor®; Applying the Teaminvest investment methodology; Calculating the price to pay and when to sell; and Capital Allocation Team and the final checklist. Full details of these steps are contained in the Information Memorandum. Here we just give a brief summary of the first two steps.

Conscious Investor® filters and analyses all companies listed on the ASX in three steps: Filter, Research and Return. The main components of the filter stage zero in on companies with attributes such as strong and stable growth in earnings and sales, high and consistent return on equity and not too much debt. The research stage helps to limit the results to companies for which these attributes are likely to continue. Finally, the return stage calculates what maximum price to pay to be confident about getting the required rate of return over the long term. It uses automatic margin-of-safety calculations based on stress testing the investment assumptions.

The Teaminvest Methodology focuses on the following four areas:

- How does the company make money? What is the business of the company? and Who are its customers?
- Investments should be like castles: What are unique features of the business that separate it from its competitors? These are scored in terms of strength 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.

Change of the Custodian

We are changing our Trading Platform and Custodian from Credit Suisse and J.P. Morgan to Interactive Brokers and ABN Amro Clearing. Our existing platform required three components: J.P. Morgan as the Custodian, Credit Suisse as the broker for transactions plus IRESS to transact. The new platform makes it simpler and cheaper to transact whilst still providing you with security for your assets.

Interactive Brokers

The IB trading system that has been rated as the best online broker for the second year in a row by Barron's 2013. IB itself has consolidated equity capital of more than US$5 billion and is a member of the New York Stock Exchange. For more information see www.interactivebrokers.com

ABN AMRO Clearing

The Custodian Services will carried out through ABN AMRO Clearing which is a subsidiary of the ABN AMRO group, a leading worldwide retail and commercial banking group with its Head office located in Holland. With a history dating back over 300 years and being one of the top three clearing and custodial services in the world you can be confident in the security of your assets. For further details about the group see www.abnamro.com

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