Conscious Investor® Fund
Annual Letter to Members: 2018 - 2019

Dear Fellow Member of our Conscious Investor Fund:

Welcome to our annual 2018-2019 letter. We hope you enjoy it and find it useful.

When performance of a fund is discussed, it rarely gets past the percentage growth of the dollar value (or net asset value) of an investment assuming distributions are reinvested. Rather like kicking the tyres of a car: not much of a criterion for future long-term performance. The first topic in this letter is description of two other measures we use which we think are better indicators.

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Performance: Safety, Earnings and Net Asset Value

We use three indicators for long-term performance. The first is safety: as Warren Buffett said many times, protecting capital is paramount. The second is earnings: we want to see weighted earnings per share over all the holdings, the main driver of dollar performance, growing steadily. Finally, as just described, there is the dollar growth of actual investments in our Fund by you, our Members.

1. Safety: Protecting your capital: peace of mind

Over the long-term the Australian market trends upwards, on average around 8.7% per annum since 1870. There are times, however, when the average market returns are negative. An important consideration of the Capital Allocation Team is to choose companies that are least likely to be affected by such negative periods. It then carries out tests to verify this.

Looking at rolling three-month periods starting each month since our Fund's inception, the S&P/ASX 200 Accumulation Index lost money 23 times. The good news is for 76% of those times, Fund members lost less money or actually made money. We feel pleased with this result and hope you are, too.

Specifically, the average loss of the index for the 23 losing three-month periods was -4.00%. Over these same periods, on your behalf our Fund lost a quarter as much, an average of -0.99%.

Conclusion: The Conscious Investor Fund successfully protected Members' capital during losing markets.

2. Performance: Growing the Earnings

The focus of our Fund is on great companies that have had strong and consistent growth in their earnings per share (EPS) with all the signs that this growth will continue in the future. After all, a stated purpose of our Fund is growth with peace of mind.

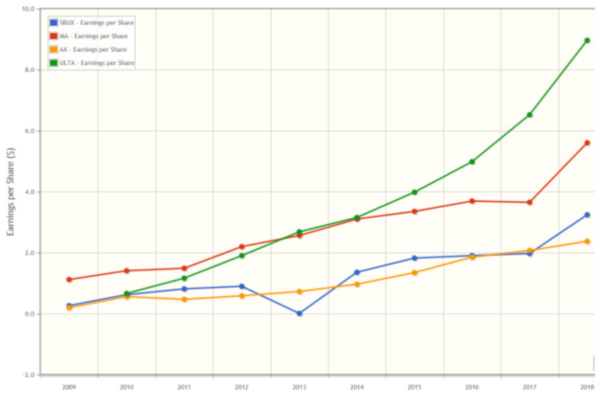
Sometimes this growth in earnings will outstrip the share prices of the companies. In this case the performance may not look so appealing in the short-term. Other times, the share prices will outstrip, on average, the growth of the earnings making the performance look better in the short-term.

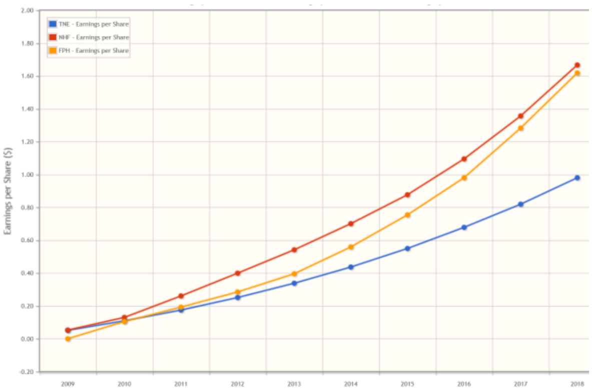
This is just the way of things.

The tell-tale sign of the first case is a falling price-to-earnings (P/E) ratio. The second case is recognised by a rising P/E ratio.

If the EPS rises (with the P/E constant) so will the price. As well, if the P/E ratio rises (with EPS constant), so will the price. This splits out two components of changes in the share price, changes due to EPS changes and changes due to P/E ratio changes.

The following two charts show the growth of EPS for major US (Starbucks, Mastercard, Axos and Ulta Beauty) and Australian (Technology one, NIB Holdings and Fisher & Paykel) Fund holdings. (The data in each chart is normalised to a common scale.)



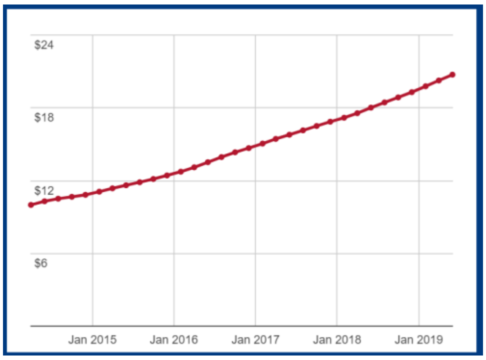


For the Fund, we need to arrive at a single EPS figure over all companies so we take into account changes in your Fund's composition. It does not happen often, but from time to time companies are completely sold or new companies are added.

For instance, we first added Starbucks in June 2018 and it is now one of the largest holdings. We also need to consider smaller changes in the percentages of the companies in our Fund.

So the data for the weighted earnings per share needs to be continually updated.

The associated chart shows the growth of the weighted average EPS since the Fund's inception assuming an initial level of $1.00. By June 2019 this has grown to $20.74, an average annual growth of 15.1%.



The constancy of the growth of weighted average EPS is primarily due to the selection criterion of stable growth of earnings. This is possible using a proprietary tool in the software Conscious Investor. It also due to the averaging effect of the EPS growths of all the companies in our Fund.

The most important consequence is over time this clear upward trajectory of earnings will convert into satisfactory performance of our Fund.

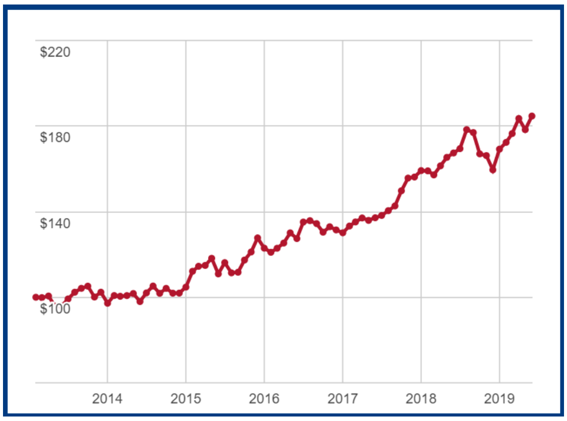
3. Growth of Net Asset Value

The financial year 2018-2019 was a solid 12 months for the Conscious Investor Fund up 10.3% (after all expenses such as performance fees and transaction costs).

The first 6 months was sluggish but was followed by a return of 15.8% for the first 6 months of 2019. A nice result for those who topped up last year or who invested for the first time. As I wrote in an email at the time, Buffett emphasises that the time to be greedy is when there is maximum fear. When the unit price is lower, you get more units for your dollars.

Stop press: As I write this Letter, I notice that the market is down today by over 1.9%. So we will be looking for Wealth Winners® for our Fund (read: homes for your money) at particularly attractive prices

The adjacent chart shows the growth of the true dollar value of an actual investment in our Fund since April 2014 after any success fees and assuming distributions (if any) are reinvested. Over this time, an investment of $100 grew to $184.67. This is a total growth of 84.67%, an average of 10.17% per year. In contrast, an investment in the S&P/ASX 200 accumulation index would have grown to $171.16, an average of 8.86% per year, over the same period.



Investing is a patient endeavour and it is only over time that consistent wealth is created.

Components of Total Dollar Return

Looking at total dollar return for your Fund, there are actually four components: Growth in weighted EPS as just discussed, growth in the weighted average P/E ratio, contribution of dividends, and the impact of foreign exchange rates. We will look at these components one at a time.

Earnings: Growth in earnings per share is the most significant factor making up over 80% of the total return since inception.

P/E Ratio: The weighted average P/E ratio has grown slightly influencing the total return by around 5%.

Dividends: Dividends from US companies are mostly lower than for Australian companies and are often zero. For instance, Berkshire Hathaway, Ulta Beauty and Alphabet (Google) don't pay any dividends. Dividends make up around 1-2% of the total return.

Exchange Rates: Investments in US companies have benefited from the decline in the Australian dollar versus the US dollar. For instance, when the first investment in Berkshire Hathaway was made in 2015, the exchange rate was 80 cents; for the most recent investment it was 69 cents. Overall, exchange rates have contributed approximately 8% of the total return.

Contributors to Performance

Even though performance of individual companies in our Fund is important, their proper importance for you is only apparent when we know how much of each company is held by our Fund. For this reason, we like to consider the absolute contribution as measured by the dollar amount contributed to the portfolio over the year.

In the information Memorandum we write: "Investing is a patient endeavour, and a time frame of five or more years is recommended."

There is good reason for this statement. It is only over time that the share price can begin to reflect the value of the underlying businesses.

Consider Technology One (TNE). Last year in the 2017-2018 Letter we wrote that one of the largest detractors was Technology One lowering overall performance by -0.9%. This year it is the opposite: TNE was the largest contributor adding +2.7% to the performance over the financial year 2018-2019.

The next three largest contributors were Ulta Beauty, Starbucks and NIB adding +2.3%, +2.2% and +1.3% respectively.

The largest detractor was Baidu, lowering the performance for the year by -2.7%.

Berkshire Hathaway Holdings

Since the combination of A and B shares of Berkshire Hathaway BH is the largest Fund holding, it is useful to know the holdings within BH itself. In its share portfolio BH holds 48 different companies. By far the largest weighting is Apple making up 23.8% of the portfolio. Banks also make up a large proportion of the largest holdings.

The following is a table of the twenty largest holdings with their industries, dollar values and weightings. (The amounts in this table and the subsequent comments are in US dollars.)

Overall you could say that we indirectly hold these companies in our Fund on your behalf. (Together the two BH holdings contributed +0.94% to the overall return.)

Ticker	Company	Industry	Value ($1000)	Weighting
AAPL	Apple Inc	Computer Hardware	47,409,494	23.8%
BAC	Bank of America	Banks	24,725,263	12.4%
WFC	Wells Fargo & Co	Banks	19,801,718	9.9%
KO	Coca-Cola Co	Beverages - Non-Alcoholic	18,744,001	9.4%
AXP	American Express	Credit Services	16,571,049	8.3%
KHC	The Kraft Heinz Co	Consumer Packaged Goods	10,631,977	5.3%
USB	US Bancorp	Banks	6,231,393	3.1%
JPM	JPMorgan Chase	Banks	6,024,697	3.0%
MCO	Moody's Corporation	Brokers & Exchanges	4,467,450	2.2%
BK	Bank of New York Mellon	Asset Management	4,081,666	2.1%
DAL	Delta Air Lines	Airlines	3,662,525	1.8%
GS	Goldman Sachs Group Inc	Brokers & Exchanges	3,523,714	1.8%
LUV	Southwest Airlines Co	Airlines	2,784,931	1.4%
GM	General Motors Co	Autos	2,681,205	1.3%
VRSN	VeriSign Inc	Online Media	2,351,700	1.2%
DVA	DaVita Inc	Health Care Providers	2,093,725	1.1%
CHTR	Charter Communications	Communication Services	1,981,103	1.0%
UAL	United Continental	Airlines	1,750,265	0.9%
USG	USG Corp	Building Materials	1,688,787	0.9%
V	Visa Inc	Credit Services	1,649,750	0.8%

The total share portfolio of BH is valued at approximately $200.5 billion. At the end of the second quarter, BH held $122.4 billion in cash and equivalents on its balance sheet.

The Ovarian Lottery

At my first Annual Meeting of Berkshire Hathaway in 1997 the duo of Warren Buffett and Charlie Munger were asked for the ideal rate of taxation on capital gains. Munger answered that Aristotle had observed that systems work best when perceived as fair.

This prompted Buffett to tell the following story about the "ovarian lottery". Suppose that you are to be born in 24 hours. Before that you are to write all the rules for the society in which you will live: political, economic, social. It could be anything from extreme communism to liberal capitalism. It could even be a monarchy or a theocracy.

You also are required to choose a lottery ticket before you are born. This ticket will decide whether you will be born gifted or retarded, healthy or disabled, black or white, male or female. Buffett asked how would you write the rules?

"How you come out in this lottery", he declared, "will be far more important than anything else in your life." Continuing "Charlie and I were huge winners."

"We were born in the US (Charlie quipped that they would probably be eaten by lions if they had been born in Africa), male (at a time when it was hard for a woman to be anything but typist or nurse)."

They acknowledged they had a talent for allocating capital at a time and place with a system that paid enormous amounts for this skill.

Expanding on this idea to a group of MBA students, he said: "You want to incentivize the top performers, don't want equality in results, but do want something that those who get the bad tickets still have a decent life. You also don't want fear in people's minds — fear of lack of money in old age, fear of cost of health care. I call this the "Ovarian Lottery.""

"My sisters didn't get the same ticket. Expectations for them were that they would marry well, or if they work, would work as a nurse, teacher, etc. If you are designing the world knowing 50/50 male or female, you don't want this type of world for women — you could get female."

He ended that it was important to take care of those that are less fortunate in this lottery. "Design your world this way; this should be your philosophy."

Building on this idea in a conversation with Barack Obama, he said: "I was lucky enough to be born in a time and place where society values my talent, and gave me a good education to develop that talent, and set up the laws and the financial system to let me do what I love doing — and make a lot of money doing it. The least I can do is help pay for all that."

World's Best CEOs for 2019

Each year Barron's publishes a list of who their editors consider are the 30 best CEOs. It is pleasing to see that four of them are CEOs in companies we hold in our Fund. In alphabetical order, they are:

Warren Buffett, CEO of Berkshire Hathaway: Apart from its stellar returns over the decades under Buffett's leadership, more importantly, he has structured the company in such a way that we can expect superior returns for many years to come, with or without Buffett at the helm. Consider for example, that he wrote: "Most of our managers are independently wealthy, and it's therefore up to us to create a climate that encourages them to choose working with Berkshire over golfing or fishing. This leaves us needing to treat them fairly and in the manner that we would wish to be treated if our positions were reversed."

Mary Dillon, CEO of Ulta Beauty: Retail growth through popular and specialist beauty brands has been led by Dillon since 2013 almost doubling the S&P500 over that time. Now has over 1,000 stores throughout the US. (If you are in the US, drop into a store and let us know what you think.)

Craig Jelinek, CEO of Costco: Expert merchandising and strategic expansion have kept Costco a retail winner. He has also increased minimum pay to $15 per hour so he has happy floor staff. Costco has slipped out of our top 10 but we would love to find an opportunity to build up our holding and get it back in. Even though it is not in our largest 10 companies, it still added +0.8% to the overall performance with solid growth in earnings per share.

Larry Page, CEO of Alphabet: Under Page (who cofounded Google), Alphabet is forging ahead on multiple fronts. Its core is Google (including Ads, Android, Chrome, Maps, Google Search and YouTube) but it also operates many other businesses ranging from Calico (aimed at combating diseases associated with aging) to Waymo (focusing on self-driving technology). For many of us there would be few days when we have not used Alphabet products.

Thank you, Warren, Mary, Craig, and Larry.

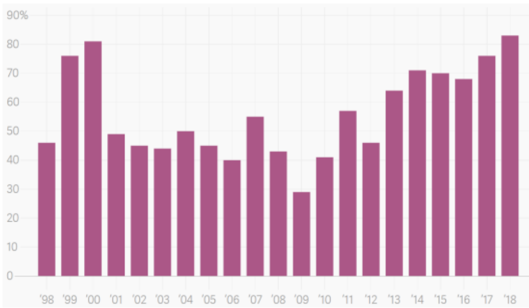
U.S. IPOs with Negative Earnings

Over any 12 months only around 30% of companies listed on the ASX make a profit. In the US it is around 50% for companies on the major exchanges. (If you include the smaller US exchanges the figure would be much lower.)

The bright side of these percentages is it that they make the job of the Capital Allocation Team much easier: we don't have to consider so many companies. If we are going to fish in a pond, at least we want to know that it contains fish.

Do you think these percentages are rather high? After all, as we have seen clearly above, it is the growth of profit expressed by earnings per share that is the primary driver of the share price.

It came as a surprise to me when I discovered a chart of US companies showing that most of these companies started that way. They had losses right from when they floated (called an IPO or initial public offering in the US). Last year it was at a record level of 81%. In this area, Uber has lots of companions. (Data from Jay Ritter, University of Florida.)



Origins of Conscious Investor®

Since the software Conscious Investor is such an integral part of our Fund, I thought you might interested in a brief look at its origins.

These can be traced back to when I started studying and thinking about share markets. This led to my wife, Sandy and me, introducing the concept and term "conscious investor". The initial meaning related to values: investing in companies with products and services that you believed in and thought brought a positive change to society. The subsequent meaning related to knowledge by inferring that most market participants were "unconscious" investors following the crowd by investing in the latest "hot" stock.

Once the concept of being a conscious investor was clear in my mind, the next stage was to expand it through developing a range of investing principles. I particularly read and studied as much of the writing of Warren Buffett I could get my hands on.

Over time I developed a number of key principles. Some of these principles were already known. Yet I found they were generally only described in a confused manner. So I rewrote them. Others were developed from scratch and are original and unique.

This stage accounted for the theory. Next I wanted to implement these principles in a practical format.

This led to initial tools for Excel that eventually morphed into Conscious Investor. In this way Conscious Investor expresses in a dynamic way the underlying principles I had developed or rewritten.

In some cases, once the principle was established, completely new methods and functions had to be developed to implement it. This was because nothing appropriate was available in the existing investment software or literature.

As an example, the return principle states that the fundamental question for an investor is what return can you be confident of achieving? This is quite different from the usual methods which were based on calculating intrinsic value using discounted cash flow (DCF) methods.

As a mathematician, I knew that while the DCF method is a fine abstract academic theory, it is deceptive if applied to real companies. For instance, minute changes in input variables can lead to changes of orders of magnitude in the outcome. Also, it contains the nonsense assumption of forecasts of interest rates out to infinity or, as one fund manager said recently, out to "Judgement Day".

This is why the growth of weighted average EPS as explained earlier is so important. Through it we are able to focus on the practical goal of estimating future returns while only sing estimates over finite periods. Even better, I introduced consistent margins of safety to give confidence in these estimates.

From here Conscious Investor quickly grew into the software we see today.

Conscious Investor® and the Teaminvest Methodology

The investment process used by the Capital Allocation Team for our Fund consists of four steps: Filtering using Conscious Investor®; Applying the Teaminvest investment methodology; Calculating the price to pay and when to sell; and a 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 in markets around the world 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 margins-of-safety calculations in Conscious Investor based on stress testing the investment assumptions.

The Teaminvest Methodology focuses on the following five areas. Wherever possible the Capital Allocation Team scores the areas to increase the precision of the decision process.

- How does the company make money? What is the business of the company? Who are its customers?
- 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.
- Does the company have a clear mission statement or noble purpose? Is there evidence that the company uses it to guide its decisions, appointments, acquisitions and remuneration policy?
- Is management honest, open and rational? As part of examining the business, evaluation is made of the board and senior management: are there any signs that they are not 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.

We hope you enjoyed reading this Letter. We chose the topics to help you better understand our philosophy and what motivates us in choosing investments for your money. Please let us know if there are any other topics you would like us to include.

We wish you health and well-being,
Kind regards,

(John Price and the Capital Allocation Team)

The Capital Allocation Team prepared this report for members of 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.

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