EGP Fund No. 1 Pty Ltd
4 35/37 Booth Street
Marsfield, NSW, 2122
Telephone: 0418 278 298

Erik A. (Tony) Hansen – Investment Manager 1 January 2014

First Half Financial Year 2014:

The general market:-

The ***Standard and Poors ASX200 Total Return Index*** (hereafter referred to as '**the benchmark**') commenced financial year 2014 (FY2014) at 39163.27 points. Including reinvestment of dividends, the benchmark finished H1 FY2014 (July 1st 2013 – December 31st 2013) at 44635.11 points.

This means that the investment experience of the Australian investing public in the stock market generally in H1 FY2014 was a gain of 13.97%. As I pointed out in the Q1 letter, you should be careful not to think of the returns of late as 'normal', for the underlying business conditions have not improved at the same rate as prices. The Australian market over the 10 years to June 30 2013 averaged a 9.2% return annually. The best year was up about 47% and the worst year was down about 42%. A reminder of this potential for volatility is important. In the year to December 31 2013, the ASX200 including dividends climbed 20.20% (37134.53 Jan 1st). If you are hoping for a repeat of the Australian indices 9.2% annual performance over the next 10 years, you should probably think of a 20.20% return year as robbing 12% out of future years' returns.

The 13.97% & 20.20% figures quoted above of course exclude management fees and costs which on average would trim between 1.5 to 2 percentage points off such a result (annually) for persons having their money professionally managed – in years when the returns are so high, people will happily pay such fees, but in a year of substantial decline, it is particularly galling to most investors to pay a fee, which is why the EGP structure requires both a positive return and a market beating performance in order to earn a fee.

The chosen benchmark over a period of years will approximate the results of leading investment companies (before fees & charges). Such investment companies are the most probable alternative investments for the majority of fellow EGP investors.

Our benchmark was selected in advance and represents the most logical choice in my view. It covers about $1.5 trillion in market capitalisation and about 80% of Australian listed stocks (by value). The chosen benchmark presents no pushover and I estimate that after fees, at least 80% of equities focused investment funds will fail to exceed the benchmark over the medium-term.

Our experience:-

EGP Fund No. 1 Pty Ltd (hereafter referred to as '**the fund**') commenced FY2014 at $1.33220. The fund finished H1 FY2014 at $1.60232, for a gain of 20.28% after allowing for all fees and expenses.

After 33 months of operation, we have continued to generate results that have eclipsed my original expectations. Our 19.80% annualised return to our holders exceeds by 11.26% the 8.54% annualised performance of our benchmark.

We continue to target 3 – 5% outperformance annually, but will happily accept outperformance at our recent levels should we find it possible to generate it safely. As I have emphasised previously, moderating your expected outperformance created by EGP is a sensible path, that way we can all be pleasantly surprised should we continue to beat the market by more than 3 – 5% annually in future periods.

I have made this comparison before and expect to do so in every report so it will not go unheeded, but a year when the benchmark declined by 35% and the fund declined by 20% would be viewed by myself as substantially superior year than one in which both advanced by 15%. If this concept makes you uncomfortable, you would be well-advised to have the majority of your wealth and investments outside of the stock-market, for it is precisely this type of out-performance we will be chasing (with the expectation that over a reasonable period, outperformance of the benchmark will lead to very satisfactory results). You should also expect approximately one in six periods to result in a negative return for the market and that EGP is unlikely to be completely immune should this happen.

Performance Tables, instructive for comparison:

Year by Year Performance			
Australian Financial Year	S&PASX200(TR)	EGP Fund No 1 Pty Ltd (A-Shares after performance fees)	EGP Fund No. 1 Pty Ltd (gross results)
2012*	-10.46%	2.99%	2.99%
2013	22.75%	32.58%[#1]	35.07%[#1]
2014 H1	13.97%	20.28%	21.85%

* 2012 is the 15 month period from 1 April 2011 (fund inception) to 30 June 2012 (first complete financial year)
#1 Assumes reinvestment of dividends

I also include a cumulative table, which I hope will demonstrate over time what Albert Einstein called "the most powerful force in the universe" – compound interest. My hope is that over time, small advantages over the benchmark will accumulate to a substantially superior overall performance:

Cumulative (compounded) Performance			
Australian Financial Year	S&PASX200(TR)	EGP Fund No 1 Pty Ltd (A-Shares after performance fees)	EGP Fund No. 1 Pty Ltd (gross results)
2012*	-10.46%	2.99%	2.99%
2013	22.75%	32.58%	35.07%
2014 H1	13.97%	20.28%	21.85%
Cumulative	25.27%	64.29%	69.51%
Annualised	**8.54%**	**19.81%**[#1]	**21.18%**[#1]

* 2012 is the 15 month period from 1 April 2011 (fund inception) to 30 June 2012 (first complete financial year)
#1 Assumes reinvestment of dividends

Our holdings remain approximately as diversified as at the Q1 report. We continue to hold 18 stocks, having added 1 and eliminated 1 in the last 3 months. Our largest (and best) 3 holdings currently comprise 51.6% of our stock portfolio (i.e. excluding cash holdings). We presently hold about 22% cash.

Dividends:-

At least in these early years, our dividend will be distributed annually and will comprise the bulk of our Franking Credits (FC's) accrued to that point. We may look to a semi-annual distribution in future. For now, you can expect to get your dividend about 1 month before the end of the financial year. We had previously announced we expected to double our 3.333c dividend (including FC's) to 6.667c in FY2014. I am pleased to say our Franking account has filled so rapidly that we expect now instead to distribute at least a 10c (7c dividend plus 3c FC) dividend in FY2014 (unless we get such a large subscription intake in March as to dilute the per-share FC balance for May's distribution), we expect we are likely to at least maintain (and hopefully grow) that level of dividends in future financial years.

Mining and Mining Services:-

I said in our FY2013 report:

"although we have some exposure to one mining company and a couple that service the mining industry, their performance was much better than their peer group. However, in hindsight, I should have had no exposure there and it has cost us a few percentage points of return."

We added a little to our mining services exposure in the quarter. The whole mining services market has been sold down lately. Overlooked in this selloff is the fact that mining 'production' is at record levels (and still growing). Companies that service production rather than exploration and have what I view as favourable business conditions (below average PPE expenditure and good cash generation etc.) do not belong in the same 'basket' although they have in some cases recently been priced as though they were. We will take advantage when such conditions exist.

We sold some of our stock in the 'one mining company' cited in the above quote in the quarter just completed. That stock (which we still maintain some exposure to) is Mount Gibson, a Western Australian Iron Ore producer. Our average purchase price for our Mount Gibson stock has been 79.99 cents per share – I bought too early...

We added to our holdings most recently in April 2013 at 49.5 cents per share. Our recent sales were executed in November at $1.12. If you want a perfect example of the bi-polar nature of the stock market, this stock should suffice. When I was buying at 49.5 cents, I was buying a company capitalised at circa $540m that carried circa $345m in net cash that had generated about $180m in operating cash in the last 12 months ($133m after paying for plant and equipment). The fully franked (grossed-up) yield at the 49.5c price was 11.54%.

I was of the view at the time of my April purchasing that FY2014 was likely to see increases in both cash-flow and dividends (the cash-flow increase now seems assured, we will have to wait to see if there is a consequent dividend increase). Mount Gibson has some issues relating to Chinese (i.e. customer) control of the board and relatively short confirmed mine-life (reserves). But it was very clearly undervalued at 49.5 cps and very good value at our average buy price of 79.99 cps. The annualised return (IRR) between the April 49.5c purchase and the November $1.12 sale including the 2c September dividend was nearly 300%. Our actual return is not that good unfortunately (as our average price was 79.99 cps and our average buy-time earlier), but given the underlying business and industry dynamics scarcely changed in the intervening 7 months, another nail in the coffin of the ‘Efficient Market Hypothesis’.

We will, I should note, very rarely own mining businesses. It is for the most part an industry with appalling economics, where managers’ incentives are too often at odds with the equity holders’ interests. But when an opportunity such as that described in the preceding paragraphs presents, you should know I will virtually always take it. Opportunities with statistically limited downside and potentially very significant upsides are how we hope to continue to create superior risk adjusted returns.

<u>Limiting our size:-</u>

I have determined that I will cap the external investment in the fund at $20 million. That is to say, once we have received $20 million of capital not controlled by myself or my immediate family, I will close the fund to new investors and probably stop taking additional investment from existing investors.

I have given a great deal of thought to this point and I am confident had we started the fund with that level of capital, the results to date would not have been negatively affected by size. However, had we been meaningfully larger than that, some of the good small opportunities would have either ‘gone begging’ or at least been so much smaller (relative to our size) that the results would have been punished.

I expect it will take us about 5 years to reach this number, so you don’t have to rush to subscribe to ensure you don’t miss out, but I am of the opinion my partners in this enterprise should know in advance how I expect to deal with their assets.

At that relatively modest size ($20m), even with (for example) a handsome 15% annual rate of compounding, it would take nearly 30 years before the pool of assets had grown to $1 billion. At $1 billion a good investment idea that you wish to put 10% of your funds into requires a $100 million opportunity. I wish to defer the point at which I face that unfortunate hurdle for as long as possible.

It is much more important to me that when I look back on my investing career that my record is excellent, not that I managed a huge pool of assets for mediocre results.

Let me hear from you regarding any questions you may have on any aspects of this letter, or anything else regarding our fund that may puzzle you.

Best Regards,

Erik A. (Tony) Hansen.
Tony@eternalgrowthpartners.com