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

Erik A. (Tony) Hansen – Investment Manager 31 December 2015

Financial Year 2016 – Half 1:

The General Market:-

The ***S&P/ASX 200 Franking Credit Adjusted Annual Total Return Index (Tax-Exempt)*** (hereafter referred to as '**the benchmark**') commenced financial year 2016 (FY2016, July 1st 2015 – June 30th 2016) at 50922.68 points. Including reinvestment of dividends, the benchmark finished the first half of FY2016 at 51446.98 points.

The average Australian investing experience in the stock market during H1FY2016 was a gain of 1.03% including reinvestment of dividends.

The 1.03% figure quoted above excludes management fees and costs, which on average trim about 1.5 percentage points off results (annually) for persons having their money professionally managed. When the returns are high, people will happily pay such fees, but in periods of substantial decline, or flat performance such as we have seen of late, most would find it particularly galling to pay for poor returns. This is why the EGP structure does not earn a fee for a negative return, nor for a performance that falls short of the benchmark.

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 when they seek exposure to equities.

Our benchmark was selected in advance and represented a logical choice in our view. It covers more than $1.5 trillion in market capitalisation and over 80% of Australian listed stocks by value. The chosen benchmark presents no pushover. After fees; nearly 80% of active managers will fail to exceed the benchmark over the medium-term. A research report was included in the FY2015 annual letter explaining this fact in more detail.

Our Experience:-

EGP Fund No. 1 Pty Ltd (hereafter referred to as '**the fund**') commenced FY2016 at $1.57872. The fund finished H1FY2016 at $1.66153, for a gain of 5.25% after allowing for all fees and expenses. Qualitatively, the result in the first half of FY2016 has been one of our best 6 month periods since inception. Valuation gains came for reasons we had anticipated. We made some small short-term gains in a couple of 'arbitrage' type transactions to augment the result slightly. Despite a fairly sound performance in a challenging market, we have a strong sense that the underlying intrinsic valuation of our holdings grew yet faster than that.

Results should really be considered over the longer term, preferably 3 – 5 years. The fund is now just three months shy of the 5 year mark, and has returned 15.15% annually after all fees and expenses. The benchmark over this period has delivered 6.98% annually. The 8.17% advantage we have generated to date has exceeded our target of 3-5% annually; we hope to continue to deliver satisfactory outperformance measured over a reasonable period. Full performance history is set out in Appendix 1. Current opportunities in the market to deploy capital into high quality stocks at reasonable valuations remain quite satisfactory in our view.

As always, fellow investors in EGP should remember that any year when the benchmark declined by 35% and the fund declined by 20% would be viewed as a substantially superior year to one in which both advanced by 15%. Ordinarily, we expect our best chance of outperformance to come in periods of substantial decline. In the event of a sharp rise, we will generally be happy just to keep pace.

If the concept of holding an investment capable of substantial decline in the short-term 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 the type of outperformance described above that we will be chasing. The expectation that over a reasonable period, outperformance of the benchmark will lead to very satisfactory results has borne out so far. You should also expect at least one in six periods to result in a negative return for the benchmark and that the fund is unlikely to be completely immune should this happen.

The fund ended H1 FY2016 with holdings numbering 27. We are still holding a few tiny positions in some stocks where we were attempting to generate some entrepreneurial gains and a satisfactory resolution has yet to present itself, or has presented but is still some time away. One of these small positions is a holding in the NSX listed Premium Income Fund (PIN.NSX). Premium Income Fund has a long and colourful history, which I won't detail here (search Octaviar/MFS if such things interest you – Octaviar even has a Wikipedia entry, though much out of date). We commenced building a position in part because the assets were available on market at a deep discount to the recently liquidated assets value and in part because the entity carries more than $200 million in tax losses pertaining to their unfortunate history, which could be valuable if a means of employing them were to be found. Contact was made with the company regarding their intentions with the cashed up shell that houses the losses, but we only managed to acquire less than a million shares before the entity announced it would be delisting and returning the remaining capital to shareholders. What will become of the retained losses, we can't be sure, but it will be a terrible shame to see them disappear into the ether. We will make a couple of thousand dollars out of our work around PIN, and despite EGP being a small fund; it will not budge the needle in the slightest. The time and effort expended in PIN will not have an enormous payoff, but it has piqued our interest in the optimal structure for EGP as we grow. The acquisition of a vehicle that carries meaningful losses would be potentially very useful to us, provided we can satisfy the tests required to exploit the losses. If you happen to know of someone carrying such an entity like an albatross around their neck like Coleridge's eponymous mariner, have them make contact. The issue is not solely around the minimisation of tax, but carrying usable losses allows us much more flexibility in the allocation of capital. It allows ambivalence between short-term and long-term gains, whereas our present structure ensures long-term gains are far more attractive.

Our top 5 holdings currently comprise 59.2% of our stock portfolio (excluding cash holdings). Our top 10 comprise 76.8% and our top 15, 89.5%. We remain well concentrated in our best ideas.

After the December 2015 investor intake, we hold about 11.6% cash. In January, our 2.4% position in Coffey Limited (COF.ASX) will also convert into cash, unless there is some issue with the takeover, which seems unlikely. I detailed the COF takeover in a blog post, if you missed it and are interested, use the search bar on the website to find the relevant post. It remains our preference to hold a decent cash balance. Opportunities can present suddenly and not always at a time when other holdings can be satisfactorily liquidated. Cash abrogates the need to make hasty decisions about what asset is best to turn in to cash should such an opportunity arise. It will punish returns in a rising market, given short-term rates currently in the 2% range, but the optionality of a decent pool of cash has a value all its own.

Calendar 2015, whilst not quite the 'Annus Horribilus' for the broader Australian market that 2008 was, but would certainly qualify as 'Annus Mediocris', or a Latin murdering description something like it, with a return including dividends of only 4.17% over the year. Given the market headwinds this presented, 2015 after fee returns for EGP of 14.69% are pretty satisfying, though a little tailwind would be quite welcome in 2016!

Dividends:-

We have distributed 18 cents since inception, or 25.714 cent including the franking credits. At the end of the first half of FY2016, we have accumulated a little over 2 cps in franking credits, which would result in a fully franked dividend of about 4.666 cps. Unless we have very large new subscriptions, given we have another 5 months before the dividend is paid, a payment of at least 5 cps fully franked seems likely for FY2016.

We will retain our very simple dividend policy unless there is a very good reason to change it. We simply return whatever franking credits are held at the end of the tax year to our investors as a fully franked dividend.

The Good, the Bad and the Ugly:-

We recount many of our investing outcomes in the Weekly Updates on the website, but for those of you who don't always find the time, it may be instructive to recount some of the ways the returns outlined herein were created. On our way to an overall result of 14.69% for calendar 2015, there was a very wide variety of performance within the portfolio.

Firstly, the good. The best overall contributor for 2015 in terms of absolute contribution to 2015 EGP results was actually a position commenced in only July in Heritage Brands (HBA.NSX), on which we are already up more than 150% and which best of all, remains sharply undervalued in our estimation and a good chance of appearing in 2016's version of this list. We had a better 2015 performance with Service Stream (SSM), which including dividends returned over 160% in 2015. In hindsight we should have sized the position larger, but it was still an important contributor to our results for the year. Citadel Group (CGL) was up 87.5% before we sold at what looks to be prematurely. Gale Pacific (GAP) was up over 50% for the year, and there are a number of other holdings exceeding 30% returns for the year.

I should add at the end of our recounting of 'the good' parts of 2015 that our two largest portfolio holdings, United Overseas Australia (UOS) and Dicker Data (DDR) ended 2015 at very similar prices to the start of the year. We have received their dividends, but no meaningful 2015 capital appreciation to speak of. Despite only modest returns from these two important portfolio members, they earned their place in the recounting of 2015's 'good' because despite modest market-performance results, in my estimation, the intrinsic valuations of both businesses have advanced considerably. Think of their 2015 performance as an accrual of future 'good'.

As to the bad, I'm inclined to focus mostly on poorly sized positions, acts of omission and premature sales here. The worst premature sale for the year was actually the late 2014 disposal of our modest AMA Group (AMA) holding, which haunted our entire 2015 as the stock roughly doubled. CGL has risen by over 30% since our July sale and managements keep delivering at both of these businesses. As for the worst 2015 acts of omission, in the interest of brevity, we will select only one; it would be too painful for both of us if we recount all of these. We understood the Australian Pharmaceutical (API) business well enough, after an investor whose work I deeply respect explained the story at length (in late 2014), we stubbornly waited for a retreat below 80cps to begin a position in January. The stock has subsequently traded well north of $2 per share late in the year, for a missed 150% gain. Even if such a position is sized too small, it is still well worth having. We own a small position in Steamships (SST), which has retreated nearly 40% in 2015. SST is an excellently managed company with a lengthy history of doing very well in a number of business lines in Papua New Guinea. I had a theory that when the major LNG project was completed (the day it was switched on PNG's GDP jumped by at least a quarter) the flow through of benefits into the rest of the economy would be fairly swift (and profitable). That appears not to have been the case. We will be patient, but always looking for signs the capital would be better moved elsewhere, but a history as long and successful as SST does not happen by accident.

Two big mistakes really stand out for 2015's 'ugly'. Firstly, we commenced the year with a position in NRW Holdings (NWH) which has been a diabolical mistake in hindsight. NWH closed the year down around 80% after a contract dispute with Samsung in the delivery of a major contract at the Roy Hill mine. It's not immediately obvious what I would do to avoid a mistake such as this one, contractors will periodically face contract issues. Had the issue not arisen, it's fair to say NWH would probably have been a poor investment in 2015 anyway. All mining services businesses have suffered mightily in 2015. Decent well run businesses are trading at prices barely exceeding their cash backing in some cases, but we have yet to wade any further into the sector. There is value there, but it remains a minefield that should be navigated with extreme caution, if at all.

The second and more egregious 'ugly' 2015 error is yet to fully play out. As my partners I think it is important to report your mistakes in a timely fashion. We commenced a position in Stream Group (SGO) an insurance claims handling business in September and October, after taking the view that with the terrible FY2015 behind them FY2016 should be a watershed and the upside in the event of even a modestly good year was very, very large. Then when the first quarter results came out, I realised I had made a mistake. I started selling the position, but like many thinly traded stocks, complete exit was not easy to resolve quickly and then trading in the business was halted. The business has recently provided an update that their Queensland business lost its major client and will be placed in administration. They have yet to emerge from the trading halt, but I suspect the price punishment will be substantial as the remaining businesses in the UK & New Zealand will now have to shoulder a greater share of corporate costs. I have unilaterally marked down the position to 3.5cps, which is my wild guess where they might trade when the suspension is lifted. That is roughly half of our cost base of 6.6cps, and about 60% below the last traded price of 7.8cps. This was a lesson in trying to beat the market into a stock before it 'rerated', and one that will not soon be forgotten. It was a relatively modest position of around 1¼%, which is fortunate as we usually do not commence positions smaller than 2%, but the small size does not remove the bitter taste from my mouth. I should have waited for signs the business was turning and even if we had to pay more once evidence emerged, it would have been a better decision.

I hope that in 2016 I will have more 'Good', less 'Bad' and no 'Ugly to report. I am thankful that the forgiving nature of a well-constructed portfolio meant that even with some major errors, a satisfactory result approaching 15% was delivered in calendar 2015.

Audit and Member Audit:-

We have a volunteer for the 31 December 2015 Member Audit, to affirm the per share valuations mentioned in this letter, their verdict will be included in the Q3 letter.

We have a volunteer for the 30 June 2016 Balance Date, but do not yet have any volunteers beyond that, if you think overseeing a future Member Audit is something you'd like to do, get in touch. Unless we are flooded with new requests to be Member Auditors, we will revert to an annual Member check-up aligning with the traditional financial year audit as conducted by our regular accountants at the June 30 Balance Date.

Let me hear from you regarding any questions you may have on any aspects of this letter or anything else regarding the fund that you would like to know.

Best Regards,

Erik A. (Tony) Hansen

Disclaimer: the content of this letter should not be relied on as financial advice. Where numbers are provided, every effort was made to ensure their accuracy. Do your own research and seek financial advice where appropriate.

Appendix 1:

Investment Comparison Tables:

As explained recently, Standard and Poors developed a new index in late 2014 that adjusts the ASX200 Total Return (i.e. with dividends reinvested) for Franking Credits. Franking Credits are an important component of the investment proposition for Australian investors holding Australian shares. The ASX200 has a dividend yield of around 4%, which is customarily Franked to roughly 70%. This means the Franked component of the return on an investment in ASX200 stocks would amount to around 1% in any given year.

If you can assume that over the medium term Australian shares were to return about 8% annually (this has been the approximate historic case), 1% uplift via Franking therefore adds about 12.5% to the prospective return. This is significant and must obviously be factored for in the interests of measurement fairness. We have adopted this index as our benchmark as at 1 July 2015.

Performance Tables, instructive for comparison:

	Year by Year Performance		
Financial Year	**ASX200TRGU (Benchmark)**	**EGP Fund No 1 (after fees/costs)**	**EGP Fund No. 1 (gross results)**
2012*	-10.46%	2.99%	2.99%
2013	22.75%	32.58%#1	35.07%#1
2014	17.43%	24.71%#1	26.83%#1
2015	5.68%	9.04%#1	9.87%#1
2016H1	1.03%	5.25%	6.30%

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

We include below a cumulative table, which we hope will demonstrate over time what Albert Einstein called “the most powerful force in the universe” – compound interest. The hope is that over time, small advantages over the benchmark will accumulate to a substantially superior overall performance:

	Cumulative (compounded) Performance		
Financial Year	**ASX200TRGU (Benchmark)**	**EGP Fund No 1 (after fees/costs)**	**EGP Fund No. 1 (gross results)**
2012*	-10.46%	2.99%	2.99%
2013	22.75%	32.58%#1	35.07%#1
2014	17.43%	24.71%#1	26.83%#1
2015	5.68%	9.04%	9.87%
2016H1	1.03%	5.25%	6.30%
Cumulative	37.80%	95.42%#1	106.06%#1
Annualised	**6.98%**	**15.15%#1**	**16.44%#1**

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