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Erik A. (Tony) Hansen – Investment Manager 30 June 2015

**Financial Year 2015:**

The General Market:-

The ***Standard and Poor's ASX200 Total Return Index*** (hereafter referred to as '**the benchmark**') commenced financial year 2015 (FY2015) at 45991.23 points. Including reinvestment of dividends, the benchmark finished FY2015 (July 1st 2014 – Jun 30th 2015) at 48602.26 points.

The Australian investing experience in the stock market generally during FY2015 was a gain of 5.68% including dividends. Q4 saw the market decline by 6.66% including dividends.

The 5.68% figure quoted above excludes management fees and costs, which on average would trim about 1.5 percentage points off results annually for persons having their money professionally managed. In years when the returns are high, people will happily pay such fees, but in a year of substantial decline, it is particularly galling to pay for poor returns. This 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 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 is included at the end of this letter from 2012, which indicated 69% of active equity funds had failed to beat their benchmark over 5 years. When you factor for survivorship bias (i.e. only around 80% of funds at least 5 years old were still operating – it's fair to assume most of those shut down were poor performers) a number near 80% is reasonable.

Our Experience:-

EGP Fund No. 1 Pty Ltd (hereafter referred to as '**the fund**') commenced FY2015 at $1.56145. The fund finished FY2015 at $1.57872, for a gain of 9.04% after allowing for all fees and expenses (the calculated gain adds back in the 12.381 cents in grossed up dividends paid on 31 May 2015). The gain of 2.18% for the fund in a quarter when the market retreated by 6.66% was especially satisfying. The important gains often come by protecting your capital in down markets.

Results should really be considered over the longer term, preferably 3 – 5 years. The fund has now operated for 4 years and 3 months returning 15.67% annually after all fees/expenses. This exceeds the 7.58% annualised performance of our benchmark by 8.09%. The full performance history is set out in Appendix 1. We consider the market to be back near the reasonably valued range. We can report we are still finding solid opportunities to put our capital to work in businesses that should provide sound returns over the next few years. Best of all, the majority of these holdings have next to no correlation with the behaviour of the broader market, which is why the fund often turns in a respectable performance when the market starts to wobble.

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 this type of out-performance 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 market and that the fund is unlikely to be completely immune should this happen.

The fund ended the period with holdings numbering 27, this is down 1 on last quarter, the disposals were ICS Global (ICS) and Codan (CDA), two of our smaller holdings, as we try to ensure our capital is concentrated in the best opportunities. More detailed descriptions of our reasons for disposing were set out in the weekly blogs. We did start a small new position (truly small at this early stage, it was just 0.3% of the portfolio at June 30) it will hopefully become a larger position and will be explained more fully once the transaction has played out.

Our 4 largest (and best) holdings currently comprise 60.6% of our stock portfolio (i.e. excluding cash holdings). Our two smallest (outside of the newly commenced position mentioned above) are each 0.6%. After the June 2015 investor intake, we again hold about 14% cash. We still intend to further reduce the number of our holdings to something nearer to 20 over time. We in fact started selling one more position in the quarter, but prices retreated, so we retreated from the market. Our portfolio turnover in FY2015 was 15%; this is by a decent margin the largest annual turnover we have had. At this rate, we would replace the whole portfolio over 6.6 years (absolutely frantic!). Turnover in FY2016 should return to more sedate levels, perhaps averaging 10% annually, as Charlie Munger says “The big money is not in the buying and selling … but in the waiting.”

This is an under-appreciated fact, waiting is one of the hardest things for an investor to do and one of the most important if you are to be successful at building wealth. Compounding is easy to overlook year by year, but very powerful when one gets out to decades and longer. A 15% rate of compounding will double your money in less than 5 years; quadruple it in less than 10. 15% annually can grow your capital more than 16 times in only 20 years. Somewhere in the 14th year at a rate of 15% your capital starts to grow by more annually than the original capital amount contributed. But you must wait to achieve this happy result. Every time you tap your capital, or even some of the earnings it has thrown off, you harm the wonders of the compounding process.

Dividends:-

We distributed 12.381 cents per share (8.6667c dividend plus 3.7143c franking credit) by way of dividend at the end of May 2015.

This brought total fully franked distributions to 18 cents since inception, or 25.714 cent including the franking credits. Most holders would prefer to have the majority of the performance of the fund come via capital growth, but in a dividend rich country such as Australia, the future for the fund is likely to be broadly similar to the past. That is to say that given around 30% of fund gains have historically been delivered as income, you can expect a result in that range in the future. The fund has a very simple dividend policy, simply returning whatever franking credits are earned over the course of the year to our investors near the end of the tax year.

The better our return in any given year, the lower the income/dividend proportion of the returns will be. The high dividend this year relative to the total return of the fund is a product of our weakest performance for the last few years.

On Value Creation:-

We invest in order to grow our wealth. Over the last several decades, Australian equity investors have been extremely successful in respect of this. The Australian equity market has generated nearly 10% annually for decades.

| CSL | | |
|---|---|---|
| $ | (2.40) | 1/06/1994 |
| $ | 0.07 | 1/01/1995 |
| $ | 0.08 | 1/01/1996 |
| $ | 0.10 | 1/01/1997 |
| $ | 0.12 | 1/01/1998 |
| $ | 0.14 | 1/01/1999 |
| $ | 0.15 | 1/01/2000 |
| $ | 0.17 | 1/01/2001 |
| $ | 0.22 | 1/01/2002 |
| $ | 0.34 | 1/01/2003 |
| $ | 0.38 | 1/01/2004 |
| $ | 0.56 | 1/01/2005 |
| $ | 0.67 | 1/01/2006 |
| $ | 1.03 | 1/01/2007 |
| $ | 1.38 | 1/01/2008 |
| $ | 2.10 | 1/01/2009 |
| $ | 2.40 | 1/01/2010 |
| $ | 2.40 | 1/01/2011 |
| $ | 2.49 | 1/01/2012 |
| $ | 3.17 | 1/01/2013 |
| $ | 3.71 | 1/01/2014 |
| $ | 4.17 | 1/01/2015 |
| $ | 259.41 | 30/06/2015 |
| | 27.7% | IRR |

This nearly 10% has been the average, but no-one really wants to be average. What we all really want is to find a company (or several companies) that can generate excellent returns and then find ways to reinvest the ensuing cash flows in more returns.

There are numerous legendary stories of value creation in the stock market. Warren Buffett's Berkshire Hathaway turned each 1965 dollar into about $17,647 by the end of 2014. This is 21.6% annually. For 50 years.

In Australia, we actually have a well-known company that actually has a much better (though admittedly shorter) track record than even Berkshire Hathaway. CSL Limited listed in June 1994 at $2.40 per share. In 2014, only 20 years later, the annual dividend from each of these original shares is $3.71 after adjusting for the split, over 1.5x the original purchase price. ANNUALLY. The original shares traded at $259.41 each on 30 June 2015 allowing for the split (3 for 1 in 2007).

The table set out on the left shows the path each original CSL share has taken. The dividend is paid in September and March, to simplify the table it is assumed it was instead paid in full on January 1st each year. The happy result for IPO investors in CSL limited as you can see at the bottom of the table is an Internal Rate of Return of 27.7% annually.

Each $1 invested in CSL in 1994 had produced about $170 over the ensuing 21 years in time weighted money.

CSL's fans are legion among Australian investors. Any investor who has held CSL for any reasonable period of time has created a lot of wealth for themselves. Despite what appears in the table to be an easy and steady march, rest assured, no single company investment is without its difficult periods. Over 17 months from early January 2002 to early May 2003, CSL investors saw the quoted value of their shares fall by 77.3%. Warren Buffett has also pointed out that over the 50 years that he was building the record described above, Berkshire Hathaway investors experienced a reversal in share-price exceeding 50% three times.

The fund's holdings have seldom been discussed in any detail in these quarterly letters. In the discussion of shareholder value creation, we will break with that tradition in this letter to talk about our largest holding, United Overseas Australia (UOS), home to more than one quarter of our invested assets. In part, this is to set out what is truly one of the great records in Australian investing history, which as a matter of great puzzlement to those familiar with the business is scarcely known by the Australian investing public.

In 1988, UOS launched an IPO, raising $2.62 million of equity including the founders' contributions; they were initially called United Overseas Securities Limited, becoming United

Overseas Australia in 1990. CS Kong and Jim Kong are the founding shareholders, and own over 70% of UOS stock. CS and Jim are unrelated, they just happen to share a surname. CEO, CS Kong was educated at Curtin University in Perth and fellow founder Jim Kong was educated at University of Western Australia.

The less mature Malaysian stock exchange at that point probably assisted the decision to list in Australia and UOS may have expected to do more investing/developing in Australian than they have so far done. So Australia came to be the destination where the capital that created United Overseas was raised. UOS initially traded on the 'second board' of the ASX, where the market tiddlers played in the 1980's and early 1990's.

They began by building a factory that manufactured latex products, but in 1990, issued some shares to acquire the assets of Hoong Ken Housing Sdn Bhd, which had 6.5 acres of land in Setapak, Kuala Lumpur and approval to undertake a $15m development on the site. In 1990, there was another small issuance of stock for an acquisition and finally in June 1990, a swathe of options was converted, injecting the last external capital the company would ever take (saving a small issuance as a consequence of the 2007 Singapore dual-listing). In 1992, having grown the issued capital to $5.6m, they commenced quotation on the main board of the ASX, where they remain listed until this day.

UOS has never since taken another penny of shareholder capital they didn't first create themselves, with the only 'new' capital coming via the Dividend Reinvestment Plan (DRP):

| UOS | | | |
|---|---|---|---|
| $ | (1) | 31/12/1987 | Initial capital |
| $ | (435,000) | 31/12/1987 | Issued for cash |
| $ | (1,318,599) | 17/02/1988 | IPO issue |
| $ | (867,800) | 10/06/1988 | Rights issue |
| $ | (4,800) | 30/06/1989 | Option exercise |
| $ | (2,814,630) | 30/06/1990 | Option exercise |
| $ | (240,384) | 30/06/1990 | Issue @ 20 cents |
| $ | 1,134,586 | 30/08/1994 | Cash dividend payment |
| $ | 760,751 | 30/08/1995 | Cash dividend payment |
| $ | 101,165 | 30/08/1996 | Cash dividend payment |
| $ | 118,280 | 30/08/1997 | Cash dividend payment |
| $ | 95,012 | 30/08/1998 | Cash dividend payment |
| $ | 153,841 | 30/08/1999 | Cash dividend payment |
| $ | 311,000 | 30/08/2000 | Cash dividend payment |
| $ | 531,082 | 30/08/2001 | Cash dividend payment |
| $ | 668,000 | 30/08/2002 | Cash dividend payment |
| $ | 685,000 | 30/08/2003 | Cash dividend payment |
| $ | 191,000 | 30/08/2004 | Cash dividend payment |
| $ | 260,000 | 30/08/2005 | Cash dividend payment |
| **$** | **10,710,754** | **16/01/2006** | Capital returned after listing of UOAREIT |
| $ | 254,000 | 30/08/2006 | Cash dividend payment |
| $ | 250,000 | 30/08/2007 | Cash dividend payment |
| $ | (16,714,500) | 20/12/2007 | Ordinary shares issued at $0.3039 per share fully paid pursuant to the company's secondary listing on the Singapore Stock Exchange. |
| $ | 716,000 | 30/08/2008 | Cash dividend payment |
| $ | 1,792,000 | 30/08/2009 | Cash dividend payment |
| $ | 1,421,000 | 30/08/2010 | Cash dividend payment |
| $ | 1,067,000 | 30/08/2011 | Cash dividend payment |
| **$** | **81,376,000** | **28/12/2011** | Capital returned after listing of UOADB |
| $ | 1,048,000 | 30/08/2012 | Cash dividend payment |
| $ | 1,359,000 | 30/08/2013 | Cash dividend payment |
| $ | 1,084,000 | 30/08/2014 | Cash dividend payment |
| $ | 946,719,000 | 31/12/2014 | Current NTA per 2014 Annual Report |
| | 23.5% | IRR | |

For a similar comparison to the CSL table, the UOS table shows how the capital has been put to work ever since IPO. In so far as the information was available, we have attempted to accurately capture the dividends paid in cash by the company for the table. For example, in 1997, the company declared dividends of $1,896,682, but due to the high participation in the DRP (even in 1997, participation was 93.8%), meaning of the $1,896,682 dividend declared only $118,280 left the company in the form of cash, with the remainder staying within the company's calculated assets. Therefore, the $118,280 outflow is all that is shown in the table. The proportion of the dividend distributed in cash has been shown in each year where records for it can be found. In the same way as with CSL, for simplicities sake, the dividend is grouped into a single annual payment, rather than the interim/final that was actually paid. The effect on IRR will be immaterial.

The table shows the growth in Net Tangible Assets (NTA) at an IRR of 23.5% indicating each $1 UOS were given at IPO has created about $300 of economic value for its owner over the 27 years UOS has been listed. The shareholder since IPO has not captured the full value creation however, because UOS trades at roughly 2/3 of current NTA. This means that although the underlying value of the assets built up over 27 years is $300 per 1988 $1, the current market value of each 1988 $1 is more like $200.

By way of comparison, had you purchased Berkshire Hathaway shares in 1965, when Warren Buffet took control, in the first 27 years, the book value per share grew by 23.9% annually. UOS has not fallen meaningfully short of this mark to date (0.4% annually).

You may well be thinking "but buying shares is a forward looking exercise…" Well despite what all the literature, and your financial advisors may tell you about 'the past being no indicator of future results', much experience shows, particularly when evaluating managements, the past is among your most valuable indicators of how things are likely to be in the future. The buyer of Berkshire Hathaway at $9,050 in 1992, after Warren Buffett already had 27 years of Berkshire Hathaway road behind him did ok, though admittedly at a slowing rate of return, to the tune of:

- 5 year return – 30.4% annually – A-share price $34,100
- 10 year return – 23.6% annually – A-share price $75,600
- 15 year return – 18.1% annually – A-share price $109,990
- 23 year return – 15.0% annually – A-share price $226,000

In 1992, Buffett was 62 years old. CS and Jim Kong are 73 and 62 respectively (2014 UOS annual report). If they have good health, and decide to stick at it, they will have sufficient time left to ensure their record continues to be among the best ever established.

If they want to compete with Buffett's later record, they have a chance too. In 1992, Berkshire Hathaway was a conglomerate with a market capitalisation exceeding $10 billion. UOS is a laser-focused property developer/owner with a current market capitalisation of less than $700m and a huge cash war chest.

It beggars belief (to your author at least) that a company with a 27 year long track record of growing tangible shareholders' equity at a rate exceeding 23% annually trades at a discount to book valuation, much less the 33 or 34% discount that it currently trades. In 1992, after 27 years of near 24% annual book value growth, Berkshire Hathaway traded at a meaningful premium to book valuation. That premium has averaged more than 30% over the last 23 years (even as the levels of return being generated slowed).

CS and Jim Kong between them control about 70% of the equity of UOS, so what they choose to do is what will happen when it comes to UOS. If you decide to join them as a shareholder, you need to make peace with that. If you join EGP, that peace has been made on your behalf!

If the example above isn't the best indicator that efficient market hypothesis fails, and fails in investable scale, then I'd love to hear from anyone who thinks they have a better example.

CSL, after more than 20 years of delivering for their shareholders trades at earnings multiples of about 22 or 23 times what they will earn in FY2015. This high multiple of their earnings is deserved; they have delivered over and over and again and again for their shareholders, such businesses are almost universally awarded a multiple that reflects such a long and growing track record of success. They also trade at around 15 times their tangible book value.

UOS trades at less than 7 times FY15 earnings and about 0.66 times tangible book. The two businesses, despite having delivered similarly strong outcomes for their shareholders, could scarcely be valued more differently at market.

EGP's investment style is to spend our time trying to ferret out companies that have this 'value creation gene'. Finding companies that have a history of delivering for shareholders is the easy part. Finding them at very cheap prices is harder. If you can do so, you get the opportunity to participate not only in the underlying value creation capabilities of the business, but with the downside protection of an inexpensive purchase price. This is how real wealth is created. The buyer of CSL at $52 per share in January 2002 has earned an annualised rate of return of about 14.4%, despite paying what must have looked like an insane multiple of about 70 times earnings. Good businesses can sometimes save you, even when you pay a silly price. By way of comparison however, the buyer at $11.80 per share in May 2003 has earned an annualised rate of return of 32.8%.

UOS, at 66% of NTA and 7 times earnings feels more like May 2003 CSL than like January 2002 CSL.

UOS is a relatively illiquid stock. This is to the advantage of the small investor, as it keeps most institutions at bay. Over the last 3 years, only 28,354,400 shares have traded. Of the 783 trading days in this period, UOS did not trade at all on 307 days, or around 40% of the time. At the current price of 54 cents per share, this means that on average, a little over $5 million of stock changes hands annually. This is more than enough for a little fund like ours to build a meaningful position to wait and see if CS, Jim and their team can continue to quietly deliver a level of performance that has been matched by very few ASX listed companies.

Copies of the 1990 United Overseas Australia annual report and a research report written by Huntleys in 2000, when the UOS had a market capitalisation of $38.4m are available on request. Very sincere thanks go to UOS company secretary Alan Winduss who provided this information requested, and who has been most helpful in the nearly 8 years I have been a shareholder of UOS in understanding the business.

To give you an understanding of how the assets attributable to shareholders perform in a well-run property development business, the following is the progression of UOS' since the last meaningful equity injection in 1990:

- 1990 - $6.4m
- 1991 - $6.7m
- 1992 - $7.0m
- 1993 - $8.4m
- 1994 - $8.1m
- 1995 - $11.3m
- 1996 - $15.2m
- 1997 - $16.2m
- 1998 - $20.8m
- 1999 - $25.3m
- 2000 - $39.7m
- 2001 - $49.3m
- 2002 - $50.4m
- 2003 - $95.1m
- 2004 - $114.7m
- 2005 - $163.0m

- 2006 - $169.9m
- 2007 - $235.3m
- 2008 - $340.0m
- 2009 - $365.0m
- 2010 - $446.9m
- 2011 - $632.5m
- 2012 - $694.4m
- 2013 - $844.8m
- 2014 - $946.7m

Wasn’t there an Asian Financial Crisis in 1997? Wasn’t there a Global Financial Crisis in 2008? Good managements seem to find a way to make the difficult look easy.

Audit and Member Audit:-

The audit for FY2015 will commence shortly. Our Member Auditor will receive contemporaneously all the same materials our Auditors receive and will be able to ask any questions deemed necessary to satisfy themselves the assets of the fund are accurately reported in our documentation. As with previous years, all members will receive the audited financial statements once they are available.

We have a volunteer for the 31 December 2015 audit, but do not yet have any volunteers beyond that, so if you think overseeing a future Member Audit is something you’d like to do, let me know. You can relax in the knowledge that we will still have our regular audit, but I rather like the rigor of knowing that eyes with a financial rather than professional interest in the underlying figures are reviewing the fund.

Let me hear from you regarding any questions you may have on any aspects of this letter or anything else regarding our 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:

An adjustment has been made to the below tables to include the performance of the oldest ASX200 tracking exchange traded fund (ETF). This has been done because the benchmark we are using does not 'gross up' for franking credits, so it is possible units in such an index-tracking fund make for a better investment comparison as the franking credits are definitely a legitimate part of the earnings for an Australian investor. I do not like to change benchmarks mid-stream, but from FY2016 onward, we will use STW.ASX units as our comparison as the franking credits within the STW ETF have provided an average annual 0.89% uplift to earnings compared to the ASX200TR index. We will therefore be comparing ourselves to a more challenging, but I think fairer investment alternative henceforth.

Performance Tables, instructive for comparison:

| | Year by Year Performance | | | |
|---|---|---|---|---|
| **Financial Year** | **ASX200TR (Benchmark)** | **STW.ASX Units** | **EGP Fund No 1 (after fees/costs)** | **EGP Fund No. 1 (gross results)** |
| 2012* | -10.46% | -8.78% | 2.99% | 2.99% |
| 2013 | 22.75% | 23.81% | 32.58%#1 | 35.07%#1 |
| 2014 | 17.43% | 18.82% | 24.71%#1 | 26.83%#1 |
| 2015 | 5.68% | 6.43% | 9.04%#1 | 9.87%#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

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** | **ASX200TR (Benchmark)** | **STW.ASX Units** | **EGP Fund No 1 (after fees/costs)** | **EGP Fund No. 1 (gross results)** |
| 2012* | -10.46% | -8.78% | 2.99% | 2.99% |
| 2013 | 22.75% | 23.81% | 32.58%#1 | 35.07%#1 |
| 2014 | 17.43% | 18.82% | 24.71%#1 | 26.83%#1 |
| 2015 | 5.68% | 6.43% | 9.04% | 9.87% |
| Cumulative | 36.40% | 41.26% | 85.68%#1 | 93.85%#1 |
| **Annualised** | **7.58%** | **8.47%** | **15.67%#1** | **16.85%#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

S&P DOW JONES INDICES

# S&P INDICES VERSUS ACTIVE FUNDS SCORECARD (SPIVA® AUSTRALIA SCORECARD)

Mid-Year 2012


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## Summary


- A majority of active funds underperformed their respective benchmarks across all asset classes studied in the SPIVA Australia Scorecard. With the exception of the Australian equity small-cap category, at least 70% of active retail funds underperformed the benchmark over the last year. The same is true for the three-year period.
- Over the last five years, approximately 69% of active retail Australian equity general funds failed to beat the S&P/ASX 200 Accumulation index. The portion of funds that failed to beat the index increased to an even larger majority across the one-year and three-year time periods, with at least 72% of active Australian equity funds failing to beat the index.
- Active Australian equity small-cap funds significantly outperformed the benchmark across all periods studied in this report. Over the last five years, almost 80% of active Australian equity small-cap funds outperformed the S&P/ASX Small Ordinaries Index. Both the equal- and asset-weighted average returns of the active fund category far outperformed the S&P/ASX Small Ordinaries Index across all periods studied.
- Almost 90% of active international equity general funds underperformed relative to the benchmark over the last year. Over both three- and five-year periods, at least 72% of international equities general funds failed to beat the index. The asset-weighted returns of this category are also converging closer toward equal-weight returns for the first time since the SPIVA Australia Scorecard was introduced in August 2009, suggesting that larger funds are not performing as well as they did in previous periods.
- All active retail Australian bond funds studied in this report failed to beat the S&P/ASX Australian Fixed Interest Index over the last year. Similarly, 92% of funds in this category underperformed the index over a five-year period, which is also consistent with the poor survivorship rates for the category. Over the last five years, active Australian bond funds suffered the lowest survivorship rate across the universe of funds studied in this report, as approximately 30% of active bond funds failed to survive.
- In spite of the poor peer group performance of active Australian bond funds relative to the index, the equal-weighted average return of the peer group outperformed other asset classes over a five-year period.


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- Approximately 86% of active Australian A-REIT funds failed to beat the S&P/ASX 200 A-REIT Index over the last year. However, the portion that underperformed falls to approximately 65% over a five-year period. Active Australian equity A-REIT funds enjoyed among the highest survivorship rates when compared to the other active categories covered in the SPIVA Australia Scorecard.

- The asset-weighted returns of all peer groups observed in this report are higher than their respective equal-weighted returns across nearly every time period that has been observed, indicating that larger funds generally perform better in each of these peer groups.

## A UNIQUE SCORECARD FOR THE ACTIVE VERSUS PASSIVE DEBATE

The S&P Dow Jones Indices Active Versus Passive Funds Scorecard (SPIVA Australia Scorecard) presents the performance of actively managed mutual funds as compared to relevant benchmark indices. Covering funds in Australia and comparing them to various Australian market indices in their respective categories, the popularity of SPIVA stems from a few unique attributes:

- ***Survivorship bias correction:*** Many funds might be liquidated or merged during a period of study. However, for someone making an investment decision at the beginning of the period, these funds are part of the opportunity set. Unlike other commonly available comparison reports, the SPIVA Scorecard accounts for the entire opportunity set – not just the survivors – thereby eliminating survivorship bias.

- ***Apples-to-apples comparison:*** Fund returns are often compared to those of popular benchmarks regardless of their investment category. SPIVA Scorecards avoid this pitfall by measuring a fund's returns against the returns of a benchmark appropriate for that particular investment category.

- ***Asset-weighted returns:*** Average returns for a fund group are often calculated using only equal weighting, which results in the returns of an AUD 10 billion fund affecting the average in the same manner as the returns of an AUD 10 million fund. Equal-weighted returns measure average fund performance, while asset-weighted returns measure the performance of the average invested dollar. The SPIVA Scorecard offers both equal- and asset-weighted averages.

The SPIVA Australia Scorecard builds upon the reputation and success of the SPIVA Scorecard in the United States, where it has been widely recognized among financial advisors, institutional investors and the media. Like its global counterparts, the SPIVA Australia Scorecard does not make investment recommendations or offer comments on the suitability of either index or active investing. The Scorecard simply reports periodic data according to the SPIVA methodology and provides a brief analysis. To better understand how the data is derived, please see the methodology beginning on page 3 of this document.

SPIVA Scorecards are the only comprehensive, periodic and publicly available sources of such data, and can be found online at **www.spindices.com/spiva**.

# UNDERSTANDING BEFORE INVESTING

Like all forms of investing, managed fund investing must begin with understanding not only the funds, but also the fund categories being considered. SPIVA Scorecards go beyond providing simple performance data for each fund category to offer detailed apples-to-apples comparisons corrected for survivorship bias, as well as asset- and equal-weighted peer averages.

We believe that planners, brokers and investors should be aware of the overall objectives and costs of their actively managed funds, and should understand the experience, investment styles and strategies of their fund managers. They should also understand the strengths and weaknesses of the funds' performance benchmarks and available passive investment vehicles. The SPIVA Scorecards serve as clean, unbiased reports on the ongoing active versus passive debate. Readers will need to make their own judgments about where to invest, and just as importantly, where not to invest. The Nobel Prize-winning professor, William F. Sharpe, sums it up:

*Should everyone index everything? The answer is resoundingly no. In fact, if everyone indexed, capital markets would cease to provide the relatively efficient security prices that make indexing an attractive strategy for some investors. All the research undertaken by active managers keeps prices closer to values, enabling indexed investors to catch a free ride without paying the costs. Thus there is a fragile equilibrium in which some investors choose to index some or all of their money, while the rest continue to search for mispriced securities.*

*Should you index at least some of your portfolio? This is up to you. I only suggest that you consider the option. In the long run, this boring approach can give you more time for more interesting activities such as music, art, literature, sports, and so on. And it very well may leave you with more money as well.*

**William F. Sharpe, 2002**[1]

# SPIVA METHODOLOGY

## *Data*

We obtain a data feed of monthly fund data from Morningstar® Australia covering all managed funds for which data are available for a given month-end date during the performance period. The data feed includes the most comprehensive Australian data on active, closed and finalized (merged or liquidated) funds over the chosen period. We apply the following filters to ensure that an equitable comparative analysis is made:

- Only open-end unlisted retail unit trusts are selected.
- Small funds with less than AUD 5 million in market capitalization are excluded in an effort to report on fund performance that predominantly relates to investor experience. To this end, we remove as many versions, or share classes, of a fund as possible.

The following identifiers are available on a monthly basis:

- Fund name
- Fund identifier
- Month and year
- Fund returns for the month, including distributions
- Fund assets under management in that month
- Fund categorization in that month
- Management type, i.e., whether the fund is indexed or actively managed

We then limit our subset using the following filters:

- We choose funds that are actively managed, excluding index funds.

[1] **www.stanford.edu/~wfsharpe/art/talks/indexed_investing.htm**

- We remove funds that lack information on assets under management for any three-month range within the previous sixty months. Therefore, if a fund is missing net asset data for a given month, a search is conducted over three months in an effort to populate that data field. Should a three-month search fail to yield net asset data, the fund is then removed from the analysis. We remove these funds because the report on asset-weighted returns cannot be computed without fund asset information, and we wish to use a consistent data set across the four main reports provided in the SPIVA Australia Scorecard.

## Fund Categories

We choose funds that have, at any point in the previous 60 months, been classified in at least one of the following categories:

- Australian Equity General
- Australian Equity Small-Cap
- Australian Equity Real Estate
- International Equity General
- Australian Fixed Income

These categories, we believe, represent the primary categories of interest for Australian fund investors and were derived from the Morningstar Australia fund classification policy. The Morningstar classification system produces narrow style-based classifications for funds, particularly in relation to Australian and international equities. We have consolidated the style-based categories in order to generate a larger sample size and develop a broad-market comparison to market-based benchmarks. A narrow style-based comparison would yield a limited sample size given that distinct value and growth style segments are not consistently discernible over the last five years. We have mapped Morningstar categories to SPIVA peer groups in the following manner:

| Morningstar Category | SPIVA Category |
|---|---|
| Equity Region Australia Large Value | |
| Equity Region Australia Large Blend | **Australian Equity General** |
| Equity Region Australia Large Growth | |
| | |
| Equity Region Australia Mid/Small Value | |
| Equity Region Australia Mid/Small Blend | **Australian Equity Small-Cap** |
| Equity Region Australia Mid/Small Growth | |
| | |
| Equity Region World Large Value | |
| Equity Region World Large Blend | **International Equity General** |
| Equity Region World Large Growth | |
| | |
| Australian Bonds | **Australian Bond** |
| | |
| Equity Sector Australia - Real Estate | **Australian Equity A-REIT** |

It is very unlikely that funds will change from one category to another due to the broad nature of the groups that have been selected, which allows the SPIVA Scorecards to provide consistent comparisons over time.

## Benchmarks

The chosen benchmarks are shown in the table below. All index returns are total returns (i.e., include dividend reinvestment) in Australian dollars. There has been no deduction from index returns to account for fund investment expenses. Active fund returns are after expenses, but do not include loads and entry fees.

| SPIVA Category | Market Index |
|---|---|
| Australian Equity General | S&P/ASX 200 Index |
| Australian Equity Small-Cap | S&P/ASX Small Ordinaries Index |
| International Equity General | MSCI World Ex Australia Index |
| Australian Bond | S&P/ASX Australian Fixed Interest Index |
| Australian Equity A-REIT | S&P/ASX 200 A-REIT Index |

The benchmarks chosen are the most commonly adopted benchmarks for funds that fall into the respective fund peer groups. In some instances, a fund may not adopt the benchmarks stipulated above. However, a vast majority do set their performance hurdle based on the assigned benchmarks in this report, ensuring that the study is robust and fair.

# SCORECARD RESULTS

## *Australian Equity General Funds: Active Funds Underperform*

The performance of Australian equity funds has been of particular interest to Australian investors, who tend to allocate a large portion of their fund investments to domestic equities. The Australian equity market is significantly concentrated in that almost two-thirds of the market is allocated between Resources and Financials, and the top 50 stocks account for nearly 70% of the capitalization of the S&P/ASX 200. As a result, a large majority of the tradable opportunity set in Australia is heavily researched and considered highly efficient.

The S&P/ASX 200 Accumulation Index posted a positive first half for 2012 by returning 7.74%. However, this result was not enough to offset the negative end to 2011. As result, the index is down by 6.7% for the one-year period (June 2011 – June 2012), signaling another difficult year for domestic equity investors. With heightened uncertainty and variability of returns, it is evident that active funds have failed to establish any clear advantage over the benchmark index since a clear majority of funds failed to beat the index across all periods observed in the report. Report 1 shows that as of 30 June 2012, 72.73% of funds failed to beat the benchmark index YTD. Over the five-year period, the index beat 69% of active Australian equity funds, which is consistent with observations made in previous editions of the Scorecard. Report 3 and Report 4 show that the asset-weighted returns of active Australian equity funds (indicating the average return of an invested dollar) exceeded the equal-weighted returns (indicating the average return of a fund) across all periods observed in the report. Therefore, there is evidence to suggest that larger funds are performing better than smaller funds. When compared to other categories studied in this report, the active Australian equity general funds suffered the lowest equal-weighted returns over the last year.

As shown in Report 2, active funds displayed an 81.56% survivorship rate over the five-year period, which is largely consistent with other peer groups observed in this report.

## *Australian Equity Small-Cap Funds: Strong Active Performance*

Stocks within the small-cap opportunity set are relatively under-researched when compared to large-cap stocks, better enabling active asset managers to take advantage of any mispricing opportunities in the market. The S&P/ASX Small Ordinaries Index is also much less concentrated when compared to the S&P/ASX 200 Index, meaning that the small-cap equity market is not holding a large portion of funds within relatively few securities. The notion that small-cap stocks are relatively under-researched has panned out in the Australian market, where the S&P/ASX Small Ordinaries Index failed to beat a very large majority of active Australian Equity Small-Cap funds across all time periods. Almost 80% of all Australian equity small-cap funds beat the index over periods of one year or more. Equal- and asset-weighted average returns in Report 3 and Report 4 also show that active funds in this category outperformed the index across all time periods by a significant margin. Asset-weighted returns are moderately higher when compared to equal-weighted returns across all periods observed in this report. The peer group demonstrated superiority over the index and the equal-weight returns also show that Australian equity small-cap funds outperformed all other equity peer groups in this report over a five-year period. Survivorship of active funds in this peer group is relatively robust, at 82.89% over the five-year period, ranking highest among other peer groups over the same period.

## International Equity General Funds: Investors Find Quality Among Poor Performers

In addition to equity risk, many international equity funds carry currency risk. Foreign exchange markets can have a profound impact on the risk profile of international equity funds, and therefore, influence the comparative fund returns within the peer group, which does not distinguish between funds that hedge their currency exposure and those that don't. As shown in Report 1, close to 73% of funds failed to beat the MSCI World Accumulation Index over the last five years, increasing to approximately 88% when only the last year is taken into account. Report 3 shows that in equal-weighted terms, active funds in this peer group consistently underperformed relative to the index across all time periods. Report 4 shows that the asset-weighted returns of the international equity general peer group substantially outperformed the index over a five-year period. However, the asset-weighted returns of this category are also converging closer toward equal-weight returns for the first time since the Scorecard was introduced, suggesting that larger funds are not performing as well as they did in previous periods. Report 2 shows that funds in this category also have among the lowest survivorship rates over periods of three years or more.

## Australian Bond Funds: Index Superiority with a Nuance

The S&P/ASX Australian Fixed Interest Index outperformed a vast majority of the active diversified bond funds in the Australian market across all time periods. As shown in Report 1, the index outperformed all of the active funds observed in this Scorecard over the last year. The result moderately improves for the active fund category over the three-year period, with 75.76% of funds delivering returns below the benchmark. Australian bond funds also have the lowest survivorship rate of all the asset classes, as illustrated in Report 2, which shows a 73.68% survivorship rate over the last five years. This is the lowest survivorship rate that has been observed since the Scorecard was first introduced to the Australian market. Report 3 and Report 4 show asset-weighted returns consistently higher than equally-weighted returns, offering some evidence that larger active Australian bond funds perform better than smaller Australian bond funds. The asset-weighted returns of the peer group, however, still fail to beat the index returns across all periods observed. Before drawing sweeping conclusions about the merits of bond-based indices and active bond funds, it is important to consider that unlike a stock index, a broad bond index is not truly replicable; it is a measure of the market, rather than a replicable passive portfolio. Typically, passive bond portfolios hold only a small fraction of the index's securities and use optimization algorithms to match benchmarks, not unlike active funds' use of quantitative screens to beat benchmarks.

## Australian Equity A-REIT Funds: Survival of the Fittest?

As shown in Report 1, the S&P/ASX 200 A-REIT Index outperformed approximately 86.42% of active funds in the last year. However, the proportion that was outperformed by the index decreased to approximately 65.12% over five years. This active fund category enjoys the highest survivorship rate over a three-year period, as well as the second-highest survivorship rate of the last five years when compared to other peer groups, as shown in Report 2. Report 4 shows that the peer group marginally outperformed the index on an asset-weighted basis over the last five-years. However, the index prevailed as the clear winner across all other periods observed.

# REPORTS

## *Report 1: Percentage of Funds Outperformed by the Index*

This report corrects for any survivorship bias and shows the percentage of funds that were outperformed by the comparison benchmark index over the quarter, as well as the one-, three- and five-year periods. We begin with the funds listed in a category at the beginning of the period and report the percentage of funds that have underperformed the index. The fund's category at the end of the period is not considered, since the category of interest is the one at the beginning of the holding period. Therefore, fund category changes do not unduly impact the results in this report.

**Report 1: Percentage of Funds Outperformed by the Index**

| Fund Category | Comparison Index | QTR (%) | One-Year (%) | Three-Year (%) | Five-Year (%) |
|---|---|---|---|---|---|
| Australian Equity General | S&P/ASX 200 Accumulation Index | 72.59 | 72.73 | 81.12 | 69.01 |
| Australian Equity Small-Cap | S&P/ASX Small Ordinaries Index | 16.00 | 15.79 | 20.73 | 20.78 |
| International Equity General | MSCI World Ex Australia Index | 84.25 | 88.37 | 80.99 | 72.92 |
| Australian Bonds | S&P/ASX Australian Fixed Interest Index | 90.32 | 100.00 | 75.76 | 92.11 |
| Australian Equity A-REIT | S&P/ASX 200 A-REIT Index | 93.59 | 86.42 | 88.37 | 65.12 |

Source: S&P Dow Jones Indices, Morningstar. Data as of June 30, 2012. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

## Report 2: Survivorship

This report shows the number of funds that existed in a particular category at the beginning of the period in question, as well as the percentage of funds that survived until the end of the period. Once again, the fund's category at the end of the period is not considered, since the category of interest is the one at the beginning of the holding period.

**Report 2: Survivorship**

| Fund Category | No. of Funds at Start | Survivorship (%) |
|---|---|---|
| **QTR** | | |
| Australian Equity General | 262 | 93.51 |
| Australian Equity Small-Cap | 75 | 94.67 |
| International Equity General | 127 | 95.28 |
| Australian Bonds | 31 | 100.00 |
| Australian Equity A-REIT | 78 | 93.59 |
| **One-Year** | | |
| Australian Equity General | 265 | 92.45 |
| Australian Equity Small-Cap | 76 | 93.42 |
| International Equity General | 129 | 93.02 |
| Australian Bonds | 31 | 100.00 |
| Australian Equity A-REIT | 80 | 91.25 |
| **Three-Year** | | |
| Australian Equity General | 286 | 84.27 |
| Australian Equity Small-Cap | 81 | 83.95 |
| International Equity General | 141 | 83.69 |
| Australian Bonds | 33 | 84.85 |
| Australian Equity A-REIT | 85 | 85.88 |
| **Five-Year** | | |
| Australian Equity General | 282 | 81.56 |
| Australian Equity Small-Cap | 76 | 82.89 |
| International Equity General | 143 | 76.92 |
| Australian Bonds | 38 | 73.68 |
| Australian Equity A-REIT | 85 | 82.35 |

Source: S&P Dow Jones Indices, Morningstar. Data as of June 30, 2012. Charts and graphs are provided for illustrative purposes.

## Report 3: Equal-Weighted Fund Returns

This report shows the equal-weighted average returns of funds in a particular category for the quarter as well as the one-, three- and five-year periods. The eligible population in a given category is determined on a monthly basis.

For every month in the period, we calculate the simple average return of all the existing funds in each category. We then compound the returns from all the months in the period. These returns are compared to the respective benchmark index returns. Note that the population of funds used in the averaging process one month might differ from that used the next month since some funds could have merged or liquidated, new funds could have been formed and some funds could have switched categories.

Most reports that purport to show average active fund performance report on the funds in a category at the end of the period, and then take the average of their historical returns. The SPIVA methodology offers a more accurate picture of active fund performance by calculating the average performance of the active funds in existence in a given category each month – not just at the end of the period.

**Report 3: Equal-Weighted Fund Returns**

| Index/Peer Group | QTR (%) | One-Year (%) | Three-Year Annualized (%) | Five-Year Annualized (%) |
|---|---|---|---|---|
| S&P/ASX 200 Accumulation Index | -4.68 | -6.71 | 5.65 | -4.00 |
| Australian Equity General | -5.62 | -7.58 | 4.29 | -4.27 |
| | | | | |
| S&P/ASX Small Ordinaries Index | -15.30 | -14.61 | 3.39 | -8.89 |
| Australian Equity Small-Cap | -10.54 | -7.15 | 11.22 | -3.47 |
| | | | | |
| MSCI World Ex Australia Index | -3.83 | 0.10 | 3.01 | -6.10 |
| International Equity General | -5.38 | -3.63 | 1.22 | -7.22 |
| | | | | |
| S&P/ASX Australian Fixed Interest Index | 4.78 | 13.09 | 8.91 | 8.51 |
| Australian Bonds | 3.86 | 10.35 | 8.28 | 7.20 |
| | | | | |
| S&P/ASX 200 A-REIT Index | 8.76 | 11.04 | 12.27 | -12.26 |
| Australian Equity A-REIT | 7.96 | 9.83 | 11.02 | -12.85 |

Source: S&P Dow Jones Indices, Morningstar. Data as of June 30 2012. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results.

# Report 4: Asset-Weighted Fund Returns

This report shows the asset-weighted average returns of funds in a particular category for the quarter as well as the one-, three- and five-year periods. The eligible population in a given category is determined on a monthly basis.

For every month in the period, we calculate the average return by weighting each fund's return by its month-end assets. We then compound the returns from all the months in the period and compare the returns to the benchmark returns. Note that the funds used in the averaging process in one month might not be the same as those used the next month since some funds could have merged or liquidated, new funds could have been formed and some funds could have switched categories.

**Report 4: Asset-Weighted Fund Returns**

| Index/Peer Group | QTR (%) | One-Year (%) | Three-Year Annualized (%) | Five-Year Annualized(%) |
|---|---|---|---|---|
| S&P/ASX 200 Accumulation Index | -4.68 | -6.71 | 5.65 | -4.00 |
| Australian Equity General | -5.28 | -7.09 | 4.45 | -3.80 |
| | | | | |
| S&P/ASX Small Ordinaries Index | -15.30 | -14.61 | 3.39 | -8.89 |
| Australian Equity Small Cap | -10.00 | -6.02 | 11.62 | -3.03 |
| | | | | |
| MSCI World Ex Australia Index | -3.83 | 0.10 | 3.01 | -6.10 |
| International Equity General | -5.21 | -2.97 | 1.05 | -5.02 |
| | | | | |
| S&P/ASX Australian Fixed Interest Index | 4.78 | 13.09 | 8.91 | 8.51 |
| Australian Bonds | 3.94 | 10.94 | 8.77 | 7.63 |
| | | | | |
| S&P/ASX 200 A-REIT Index | 8.76 | 11.04 | 12.27 | -12.26 |
| Australian Equity A-REIT | 7.60 | 9.76 | 11.06 | -12.22 |

Source: S&P Dow Jones Indices, Morningstar. Data as of June 30, 2012. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results

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