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Quarter 3 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 Q3 FY2014 (July 1st 2013 – March 30th 2014) at 45331.98 points.

This means that the investment experience of the Australian investing public in the stock market generally in the first 3 quarters of FY2014 was a gain of 15.75%, and for the quarter just finished was 1.56%. As has been mentioned in previous letters, the returns of late (perhaps the last 2 years) have been unusually good and there should be no surprise should they pause or even retract somewhat.

The 15.75% figure 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 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 Q3 FY2014 at $1.61640, for a gain of 21.33% after allowing for all fees and expenses.

Quarter 3 was a fairly ordinary one when looked at in isolation, we only managed to generate a 0.88% return, but as we have always said, the results should really be considered over the longer term. We are now 3 years old and have continued to generate results that have exceeded the 3 – 5% outperformance I had originally hoped to generate. Our 18.49% annualised return to our holders exceeds by 10.09% the 8.40% annualised performance of our benchmark.

We continue to target 3 – 5% outperformance annually (though preferably measured over 3 – 5 years to allow for volatility), but will happily accept outperformance at our recent levels should we find it possible to generate it safely. As 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.

Despite the fully valued levels of the general market, we continue to find a few opportunities that look likely to provide well above-average returns over the medium term, we discuss these in more detail below.

This comparison has been made before and we 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 as substantially superior year than one in which both advanced by 15%. The more years that go by without a substantial decline, inevitably the closer we are to a year when such an event will occur.

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 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 Q3	15.75%	21.33%	23.19%

* 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

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. 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 Q3	15.75%	21.33%	23.19%
Cumulative	27.22%	65.74%	71.37%
Annualised	**8.40%**	**18.49%**[#1]	**19.77%**[#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 have grown yet more diversified since the last report. We now own 23 stocks, having again added a few in the last quarter. Our largest (and best) 3 holdings currently comprise 50.6% of our stock portfolio (i.e. excluding cash holdings). Our smallest comprises a miniscule 0.09% (and growing – see below). We presently hold 22.6% cash.

Dividends:-

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 each financial year. We will distribute a 10c (7c dividend plus 3c FC) dividend in FY2014 on the last weekend in May. We expect to at least maintain (and hopefully grow) that level of dividends in future financial years, subject to the level of Franking Credits held (we will only pay dividends to the extent we can fully frank them).

Current opportunities:-

As mentioned in the weekly blog post a few weeks ago, we have started adding a number of new holdings, the effect of which we expect will be a substantial increase in the (fully franked) dividend yield of the fund, as these businesses at the prices we are currently attempting to acquire the stock in these 5 businesses, they yield between 6.52% and 13.33% (that's between 9.32% and 19.04% grossed up!)

The businesses above have differing growth characteristics. For example, the business with the 13.33% dividend has scarcely grown earnings in the last 5 years, its dividend has been the same for the last 5 years and I would be surprised if it grows in the future very much if at all. The protection of this very good purchase price, however is that if we manage to get the stock we're chasing for the fund at the price we're currently bidding, we will acquire a stock that will yield a grossed up 19% - we don't really need capital growth to make that investment compelling! The best part; this stock also has $3.32 of tangible assets for the price we're currently bidding (per $1 of market capitalisation), $3.15 of which is cash and is trading at around 2x the earnings of the last 12 months. You read that right, for every $1 of purchase price you get $3.15 of cash and about 50 cents of after-tax earnings.

All 5 of the stocks above are extraordinarily illiquid and we're trying to buy an amount that is equivalent to the last 3 or 4 years trading in at least a couple of the names. Barring a major change in the businesses performance, or a remarkably improved market price, once acquired, we are unlikely to ever sell these businesses, once we have acquired the full stake we want for the fund.

We will also break with tradition and give thorough backgrounds and my thoughts on valuations for these businesses once we've completed acquiring the stakes EGP is chasing. This will mean, unless the prices change meaningfully between now and when the acquiring is done that there will be some good opportunities unveiled on the blog over the coming 8 or 12 months, so keep your eyes peeled for the blog updates containing the names, particularly those of you operating SMSF's, as the high fully franked yields are particularly suited to SMSF investment.

It was noted in the last quarterly that we would be limiting our size, the small size of the aforementioned investments are the type of opportunities that would be lost with additional size. If we were more than 4 or 5 times our present assets, I would likely not make the effort to acquire these assets as they would be too small to have a meaningful effect on returns.

Member Audit:-

In conversation with a new EGP investor, who joined us in the December 2013 intake, the fund will introduce what I will refer to as a ‘member audit’.

The first of these member audits will be conducted based on the assets as held by the fund on 30 June 2014. An ‘audit pack’ will be compiled and sent to the nominated investor sometime after the end of the financial year. The member auditor will be asked to write a short report acknowledging that the assets add up to the per share value as calculated by internally. The member will be able to ask for anything they believe will help them properly assess that value, bank statements, brokerage statements and the like.

Subject to sufficient member interest, we’re considering running this process twice annually, with the member audit replacing the external audit at the half-year (31 December) audit. This will further trim our already tight cost base, which financial year to date has only cost less than $1/10^{th}$ of 1% (0.086% after 9 months including all accounting, auditing, ASIC and brokerage expenses). Without the cost of the mid-year audit, this administrative cost would be reduced further to $7/100^{th}$ of 1%, and will naturally reduce further as we manage more assets.

We already have our first nominee, a Perth based investor who will conduct the inaugural EGP member audit based on the 30 June 2014 balance date. Members interested in conducting the member audit for December 31^{st} 2014 and beyond may make contact; it will likely be a ‘first in, best dressed’ opportunity, with the second to express interest to get 30 June 2015, the third to get 31 December 2015 and so on. So if you have any interest in finding out the inner workings of your investment, express interest early.

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,

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