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<u>Quarter 1 Financial Year 2014:</u>

<u>The general market:-</u>

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 Q1 FY2013 (July 1st 2013 – September 28th 2013) at 43885.83 points. The official quarter end will be Monday 30th, but for our purposes, we are closing the quarter Friday on the figures contained within this report.

This means that the investment experience of the Australian investing public in the stock market generally in the first quarter was a gain of 12.06%. The market has started FY2014 off on a tear; it finished the second half of FY2013 on a tear too. You should be careful not to think of the returns at these times as 'normal', for the underlying business conditions do not reflect the growth in prices. What has happened is an old-fashioned 're-rating', where the price investors are willing to pay for the future earnings of listed companies has risen sharply. The rise is partly in relation to ongoing low rates available on cash holdings and partly due to the expectations of meaningful future earnings growth from an improving global economy. The future looks a lot rosier globally than at this time last year, as Buffett sagely said 'You pay a high price for a cheery consensus'.

I stated in the FY2013 Annual letter and it bears repeating, though the market has become more fully valued, there are always well priced stocks. They just take a little more selectiveness to uncover in a fully priced market.

As always, or perhaps more than ever when the market has treated us very well for a period, we must remember the sentiment and swings can occasionally operate against us. The strong gains of late could be followed at any time by a sharp contraction in prices. In fact the more pervasively positive the language of market commentators becomes, the more certain you can be that the next fall is somewhere nearby.

The 12.06% figure quoted above of course excludes 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 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 our

structure requires both a positive return and a market beating performance in order to earn a fee.

I have said previously, I believe this 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 $1.4 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 Q1 FY2014 at $1.51624, for a gain of 13.81% after allowing for all fees and expenses.

The 3-months just gone have once again been very kind to us in both absolute and in relative terms. 2.5 years of operation for the fund are complete; we have continued to generate results that eclipse my original expectations when the fund was established. Our 19.29% annualised return to our holders is 10.60% better than the equivalent performance of the benchmark (8.69% annualised to date). This continues to lead the 3 – 5% outperformance we state as our target in the 'Investment Principles and Shareholder Guidelines' documentation. I am quite hopeful of providing continued above average results long into the future, though it is reasonable to moderate your expected outperformance to be below 10.60% annually in future years.

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.

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 Q1	12.06%	13.81%	14.25%

* 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 Q1	12.06%	13.81%	14.25%
Cumulative	23.16%	55.43%	58.94%
Annualised	**8.69%**	**19.29%**[#1]	**20.36%**[#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 continue are presently more diversified than they have been in the first 2 years of the funds existence; we now hold more stocks (18) than we ever have before, having started adding a new holding just this week. Our largest (and best) 3 holdings continue to comprise about 50% of our stock portfolio (i.e. excluding cash holdings). We presently hold almost 20% cash.

Dividends:-

At least in these early years, our dividend will be distributed annually and will comprise the bulk of our Franking Credits accrued to that point. As time goes by and we have a larger pool of assets, we may look to a semi-annual distribution. For now, however, you can expect to get your dividend in the final month of the financial year. This allows tax-payers with a rate below the Australian Company tax rate to quickly have returned the credit that might be due to them from the Franking Credits. Superannuation funds are one that may make the most of this advantage.

Buy and Hold:-

The financial media has prematurely announced the death of ‘Buy and Hold’ investing a number of times. With very good businesses, or even moderately good businesses (purchased at the right price), holding for the long term remains the best option. The primary reason is taxation. Imagine every year you found an investment that would return 15% in a year, but you sold it every year to buy the next 15% p.a. opportunity, paying taxes every year of 30% (the Australian Corporate Tax Rate) out of the 15% that you earned, your return would be 30% less than 15%, only 10.5% per annum. If you instead held a 15% p.a. compounding investment for 20 years and then paid the 30% tax on the gain, your annualised return would be 13.11%. You get 2.61% bonus interest for inactivity. Doesn’t sound like much, but at the end of 20 years, your gain in the ‘Buy and Hold’ situation would be over 2/3 better than the ‘annual taxpayers’ over 20 years. I have heard this referred to in the past as being like using your unpaid taxes for leverage; it’s the best form of leverage to use if that’s the case.

You should know that the fund is generally a very long-term owner of its assets. We ‘Buy and Hold’ and with most of our assets we intend to hold for a long time. Since inception two and a half years ago, our average portfolio turnover has been 11.6% per annum. If compulsory acquisitions are removed, it is more like 7.5% p.a. I would

suspect something under 10% would be the long-term average unless the market hits a very high mark and I'm forced to increase cash holdings for valuation reasons.

There are generally only three main reasons we will dispose of a holding. The first and most obvious is in the event of a takeover/corporate event. Secondly, will be when a stock has appreciated past our assessment of the value of the business. This does not guarantee a sale, but if I can find a better application for the capital, or believe cash is safer, I will dispose such a holding. Finally, the one that will happen least often (we hope) is that the investment thesis upon which the purchase was made turns out to be wrong. In that case, we will exit in a hurry. I should point out we may occasionally also get involved in special situations or small arbitrage opportunities, but they will be extremely rare, buy and hold is the main game.

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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