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

Financial Year 2016 – Quarter 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 quarter of FY2016 at 48316.83 points.

The average Australian investing experience in the stock market during Q1FY2016 was a decline of 5.12% including reinvestment of dividends.

The negative 5.12% 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 such as the last 6 months or so, it is 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 Q1FY2016 at $1.58049, for a gain of 0.11% after allowing for all fees and expenses. Making a gain, however small for the fund, given it was a quarter when the market retreated by more than 5% was once again pleasing. The important gains really do 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 four and a half years, returning 14.77% annually after all fees and expenses. This exceeds the 5.90% annualised performance of the benchmark by 8.87%. The full performance history is set out in Appendix 1. We consider the current opportunities in the market to purchase high quality stocks at reasonable valuations to be the best they have been for at least a couple of years. Better, the majority of our 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 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 Q1 FY2016 with holdings numbering 28. This is up on last quarter, primarily due to a couple of very small positions taken for reasons I will explain in the blog or in future quarterlies as the opportunities play out. I mentioned one such small position in the June letter. This position was the NSX listed Heritage Brands Limited (HBA). HBA own a number of brands you have likely heard of and the rights to distribute a number of others. Brands such as Australis, Innoxa, InEssence, Nailene, Revlon and Skin Republic are among their distribution stable. We purchased the position mentioned in the June quarterly and applied for a large (relative to our modest capital) over-subscription in the rights issue relating to their acquisition of the Le Tan brand. We were fortunate to get the full application. The rights issue was conducted at ¾ cents per share (cps) and the stock most recently traded at 2 cps, so the transaction has been very good for us thus far. Want to support a good business that you own shares in? Visit heritagebrands.com.au, it is easy to use – I've tried it (due diligence).

HBA is however, perhaps the most thinly traded stock we have ever held, and its price could move around very substantially on very small volumes. With that said, based on the recent results and the outlook, I do not think the last 2 cps traded price overvalues the company. In fact, with the very impressive history of the recently appointed CEO Con Gendis and the trajectory of the recent sales and earnings growth, the upside looks particularly interesting at current prices. The issue is liquidity, but we join some fellow very long-term investors such as Soul Pattinson and CVC Private Equity, and an experienced board holding a very substantial stake also. If the business results are as good as I think they will be, as with most businesses, the liquidity issue will take care of itself in time.

Our top 5 holdings currently comprise 57.8% of our stock portfolio (excluding cash holdings). Our top 10 comprise 76.4% and our top 15, 87.6%. So despite our expansion to 28 holdings, we still remain very concentrated on our best ideas with our smallest 13 averaging less than 1% each and the 2 smallest 0.01% each.

After the September 2015 investor intake, we again hold almost 20% cash. We could very happily deploy more of this capital into our best ideas, but as I have stated in past letters, we will rarely get below 10% cash, even when everything looks very inexpensive. The benefits of having a reasonable cash balance on hand to deploy into opportunities that sometimes arise unexpectedly, is often more valuable than the incremental return that could be achieved by having the cash at work earlier.

Dividends:-

We have distributed 18 cents since inception, or 25.714 cent including the franking credits. At the end of the first quarter, we have accumulated about 1.5 cps in franking credits, which would result in a fully franked dividend of 3.5 cps. Unless we have very large new subscriptions, given we have another 8 months before the dividend, we should accumulate more franking credits and pay a dividend that's slightly larger than that in 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.

Luck:-

We have beaten the market for over four full consecutive years now. If we assume that beating the market is a binary outcome (either you win or you lose) in any given year, then there is less than one chance in sixteen that four and a half years of this happy result has been achieved by luck. This is about a 6% chance if the result is a simple binary outcome. When you factor in the 'margin of victory', the math gets a little trickier, but with the fund returning a little more than twice the annual return of the benchmark, the chance that this result has been achieved through luck gets much closer to zero.

But luck is one thing you will notice almost all successful investors acknowledge. Despite being born in perhaps the lower third of Australia's socio economic stratum, I was still lucky to be born in one of the richest countries in the world, so probably the top 10% of the global socio economic stratum. Good fortune struck again when a good head for numbers and a love of business turned out to be embedded in my personality. Given the rewards for such characteristics in a wealthy capitalist society, one couldn't help but feel very lucky. Born into the same socio economic stratum in virtually any country only 200 or 300 years earlier, these personality traits would have likely been virtually useless. It is entirely possible that in another 200 or 300 years such situation will again lead to no substantial economic advantage.

Interestingly however, most of what we do with your money at EGP involves trying to remove luck from the equation. Allocating our funds toward situations where the downside is meaningfully less than the upside. This is mostly a simple probabilistic matter, where a range of likely outcomes for each business is weighed over a period. For example, if you build an equally weighted portfolio of opportunities which are assessed to each have, over five years, a 1/3 chance each of:

a) Total Loss   b) Doubling of Investment   c) Tripling of Investment

If you have correctly assessed the probabilities, you should see a return of more than 10% annually over the 5-year period all else equal. Remove the prospect of 'Total Loss' however, and the expected return now exceeds 20% annually. This is why we focus so hard on the downside, the more of it we can remove, the better our returns will be. With less risk.

Audit and Member Audit:-

The audit for FY2015 was completed today. The annual accounts will accompany this report in the email. Our Member Auditor received contemporaneously the same materials our Auditors received and after asking a number of questions to satisfy his curiosity in a few areas, gave the NTA per share a pass. His words:

"I've now completed the member's audit and I'm satisfied with the calculated NTA per share. I also appreciate your thoughtful response to my questions."

We have a volunteer for the 31 December 2015 Member 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. I will likely reduce the member audit to an annual check-up at the June 30 Balance Date in future as we are not exactly being flooded with members desperate to understand the minutiae of the fund's accounts.

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.

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
2016Q1	-5.12%	0.11%	1.42%

* 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%
2016Q1	-5.11%	0.11%	1.42%
Cumulative	29.42%	85.89%#1	96.60%#1
Annualised	**5.90%**	**14.77%#1**	**16.21%#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