EGP Concentrated Value Fund

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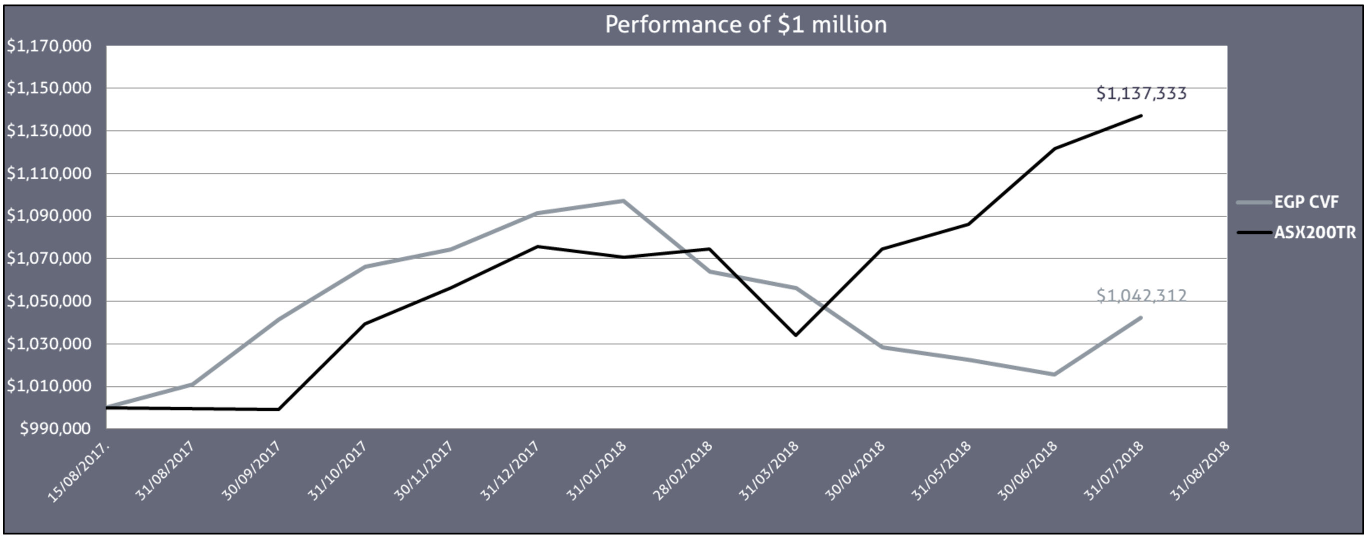
EGP Concentrated Value Fund – 31 July 2018

EGP Concentrated Value Fund is a managed investment scheme focused primarily on owning Australian listed businesses. It targets 3 – 5% annual outperformance of Australia's preeminent ASX200 index over the long term. Managed by a performance oriented co-owner, we run a portfolio that is genuinely different. The sole objective is to deliver the strongest possible risk adjusted returns. The fund manager has their entire investable asset base in the fund, meaning focus on risk is unusually intense.

EGPCVF	Jul	Aug*	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
FY18	N/A	1.1%	3.0%	2.4%	0.8%	1.6%	0.5%	(3.0%)	(0.7%)	(2.7%)	(0.6%)	(0.7%)	1.58%
FY19	2.6%												2.61%

Benchmark	Jul	Aug*	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
FY18	N/A	(0.1%)	(0.0%)	4.0%	1.6%	1.8%	(0.5%)	0.4%	(3.8%)	3.9%	1.1%	3.3%	12.18%
FY19	1.4%												1.39%

*August 2017 is the period from August 15th-31st for both the fund and the benchmark in the above tables.



The Month That Was:-

The fund rose by 2.6% in July. Our benchmark rose by 1.4%.

Going back through the record of both EGP funds since history, we have not yet had a negative return in July (October is the only other month we've not yet had a negative result). July 2018 marked the 8th consecutive positive result for the funds in the month of July. Our annualised return since inception in only the month of July is almost 50%, with an average monthly return in July's of 3.4%.

August has historically been roughly half as good as that, we average about 1.6% in the month of August since we created EGP. We are excited to see the results our holdings will deliver over August as the primary reporting season sees FY18 results unveiled and FY19 expectations set. We think there are a few positions in the fund the market is sharply mispricing; the explanation of results and setting of expectations for future years is one of the likeliest catalysts to see such mispricing corrected.

For those interested, June has been our worse month historically and the only month since EGP began where on average we have lost money, our average return in June is -0.01%. It is interesting how trends form, and our natural human tendency is to look for patterns. In truth though, the above data is probably meaningless, but it's how market aphorisms such as "sell in May and go away" develop.

The main reporting season and the lead up into it have historically been fairly rich hunting grounds for performance with the fund. The most interesting part about that is that the seeds of this performance are usually planted much earlier. Of the 3 stocks (BID, ELX & LPE) that contributed most of our gains this month, only LPE (Locality Planning Energy) have we purchased recently (in February, April, May & again in July). BID (Bidenergy) we last purchased in February. Our last purchase of ELX (Ellex Medical Laser) was likewise, in February. We will talk further below about the substantial portfolio gains generated this month by BID, which caused some unusually high levels of excitement for our normally sedate investments as the market decided very suddenly the business has a very exciting future.

And So It Begins:-

We closed the outperformance gap against our benchmark by 1.2% in July. This reduced our shortfall against our benchmark from 10.6% at the end of June to 9.4% at the end of July. Our investments are completely index unaware, but our commitment to our investors is to deliver outperformance against our benchmark over time and we remain laser focused on delivering that goal. We acknowledge, however, very little control over the ultimate timing of that outperformance.

The fund once again had a modest net inflow this month, so having snapped a five-month long losing streak; I am pleased to be able to report we had net inflows every month of that period of poor performance. This is enormously pleasing because it means as a group our investors understand what we are doing and understand that periods of underperformance are a natural outworking of a highly idiosyncratic or unconventional investment process.

As I frequently mention, although we use the ASX200TR as a benchmark (because it is the gold-standard Australian equities benchmark), we will generally vary substantially from month to month. Since the new fund was established in August last year, the absolute variation relative to the benchmark has averaged nearly 2% per month, with the widest variation over the year being a 4% divergence between EGP and the benchmark in June and the narrowest being 0.8% registered in November.

If I compare this to an alternative actively managed equity investment, such as Australian Foundation Investment Company (AFI.ASX), it has averaged only 0.3% absolute variation as against the ASX200TR over FY18, with the widest variation 0.65% (narrower than EGP's narrowest) in April 2018 and the narrowest variation of 0.02% in June 2018.

We seek to deliver results that are considerably different from the market and over a period of years, we hope, considerably better. In so doing, we are guided by Howard Marks words, ***"Unconventionality – there's the risk of being different. Stewards of other people's money can be more comfortable turning in average performance, regardless of where it stands in absolute terms, than with the possibility that unconventional actions will prove unsuccessful and get them fired… Concern over this risk keeps many people from superior results, but it also creates opportunities in unorthodox investments for those who dare to be different."*** As the owner of EGP Capital, I don't really risk being fired, but we do have a considerable amount of outside capital that could leave if our investors aren't fully convinced that our unconventionality will eventually result in positive outperformance. This is why so much attention has been paid over the past 7 or 8 years in explaining our investment process and trying to ensure our investor group understand well that there will be periods of underperformance and likewise attracting the type of investors who are able to withstand the natural instinct to flee when the results are temporarily short of expectations.

Why the Long Tail? :-

Our focus in our reporting is typically on the largest 10 or 15 holdings in the fund. This is with good reason, over the life of the fund, we have customarily had about 75% or more of our assets in our top 15 positions, though at present we're less concentrated than we'd like to be and that will be a focus for the remainder of FY19.

What we don't often focus on are the 10-25 smaller holdings that generally make up the 'long tail' of our investments. We have probably explained this before, but it bears repeating, we try to structure the portfolio in terms of maximising risk adjusted returns (the Kelly Criterion is the broad intellectual underpinning of this approach).

A simplistic way to think of this is that if we have two opportunities we assess as having similar mid-points in terms of their expected IRR over a given period (say 20% IRR over 5 years), but investment "A" we assess as having what we might describe as a 'confidence interval' of 5% to 35%, and investment "B" we assess with a confidence interval of (-10%) to 50%, then we are would invest a lot more into investment "A" than into investment "B".

Getting out into the very skinny part of the tail, we sometimes take positions that are actually assessed to have much higher IRR's than most of our largest holdings, but come with much higher overall risk, which is why they must necessarily comprise small position sizes.

One such holding is BidEnergy (BID.ASX), which was a position we accumulated between mid-October 2017 and early February 2018. Our average price on our position was 1.78 cents per share. At our average purchase price, the company was capitalised at $13.2m and we had invested 0.39% of our net worth in the business. When the share price bottomed at 0.8 cents per share in January, BID was our 2nd smallest holding out of 38 holdings and the mark and capitalised at $5.9m (less than the cash it held...).

At the time of the majority of our purchases, BID had between $6-7m in cash, but was consuming that cash at about $500k per quarter. In effect at circa $13m capitalisation, we were paying $6m for a company which had two very interesting and complementary software businesses.

The BID business is an energy management business. I won't go into extensive detail about how their two present businesses operate, if interested, you can examine them here: https://bidenergy.com/ and here: http://realwinwin.com.

I came to know about BID via a unitholder in the fund who had been part of converting their organisation to using BID to organise bill validation for a large store footprint business. The BID business is doing something in that space that to the best of my knowledge, no other competitor is doing, by using a robotic engine to read the bills, checking for errors in tariffs and completing the whole process in a matter of minutes. Competitor businesses often use foreign workers for a similar task, but without the tight timeliness BID offer.

I thought if the traction exhibited in the two businesses continued and accelerated that there was a reasonable prospect over a couple of years of making a multiple of our money. As it stands at the 13c price at the end of July, we have already made 7.3x our original investment. That being the case, one might think we'd have sold out and moved on, but we haven't and I'll explain why below. We have, however, taken our original capital out and we now have a free-carry for a stock that now speaks for about 2% of our portfolio.

They say it's better to be lucky than smart and we have certainly had luck on our side in the case of BID (which is nice because over the last few months I've felt like bluesman Albert King in the blues classic "Born Under a Bad Sign" – ***if it wasn't for bad luck, I wouldn't have no luck at all***). The luck in the case of BID has come in the form of the upcoming launch of "BID Billy", a product that will take their robotic bill-reader to the mass market.

I have seen a demonstration of the BID Billy product and as a consumer; I can't wait to use it. The customer simply drags and drops the (.pdf) of their energy bill into the portal. In a matter of seconds, it reads the bill, looks back through the household consumption over the last 12 months and recommends the retailer with the best available deal based on your consumption patterns.

Readers may think, there are already 'comparison' sites such as "Compare the Market" and "I-Select" that provide this service, but I'm here to tell you, this service is off-the-charts better. Firstly, the comparison sites are conflicted as their model requires the retailer to provide a commission for delivering the customer; this can mean that the retailer offering the best commission gets the recommendation rather than the best offer in the market. They also don't usually cover the whole market, whereas BID Billy will have every supplier in the engine.

The retailers will love the service as they won't pay for the new customers; they just need to provide the best offer. The customer will pay BID (or whoever they partner with to get distribution reach) a fee to be able to drop their bill into the engine every quarter to ensure they are still on the best tariff possible based on their location and consumption. Of the three bills (which were fairly high consumption bills to be fair) I saw dropped into the engine, the average saving provided by BID Billy was $500 annually and there were still some retailers' offerings yet to be loaded into the engine.

There is much to be excited about here (and to be fair, the business is being valued on future potential and not current operational metrics). I like it conceptually as it is the very best of capitalism, it is a frictionless way for the best offer in the market to be delivered to the greatest number of customers. It will ruthlessly drive custom to the most cost effective business. As BID Billy's distribution reach widens, they'll be able to negotiate special rates that cannot be accessed any other way, further improving the offering.

But more than that, if the product is successful, there is an array of adjacent markets the product could be applied to, Water, Gas, Telephony and Broadband come to mind immediately. Furthermore, once they can make it work, it isn't a long bow to draw to imagine versions of the product delivered into the larger global markets. BID Energy has already won at least one customer in the United States with a 49 state footprint, once the tariff structure from every state has been captured and loaded into the robotic engine, rolling out the mass-market product just requires a distribution partner with good reach into households (think cable providers or telco's).

As I mention above, the business is now being valued on potential, rather than anything about the current performance. This leaves us in a valuation quandary. Given the enormous potential of the business, we intend to manage this position on a portfolio basis rather than a pure valuation basis. We will put a ceiling on the portfolio proportion that we will allow the position to grow to. This is unfortunately a more mechanical approach than I would generally prefer, but this is a business that is probably still several quarters away from being cash flow breakeven, let alone generating profits. But the potential of the business is so enormous and we are free-carried for our position, so we will try to participate in the future of the business in a way that appropriately manages the risks to the portfolio. The share price rises and falls some days by more than our original cost base, so if nothing else it will be exciting.

Just One More Thing:-

Our second largest holding Kangaroo Island Plantation Timbers Limited (KPT.ASX) released their quarterly investor letter on the second to last day of July. To any unitholders in the fund who make direct equity investments themselves, I urge you to read the letter (and its previous issues). The communications CEO John Sergeant makes to the investors in KPT is a shining example of how small capitalisation companies should seek to educate and inform their investor group.

His missives are readable, articulate and assist shareholders and potential shareholders alike in understanding important components of the operation of the business. They do not seek to be promotional in respect of the valuation of the equity of the business, but to educate and enlighten.

He writes coherent explanations of high-level industry structures and dynamics; whilst sometimes drilling down into operational-level matters such as the types of transportation and equipment that will be used to create the most efficient possible operation and descriptions of the different end markets for hardwoods and softwoods. All this information facilitates a more complete understanding of the investment for readers.

It is an example I often encourage other CEO's to emulate. As I say, not for promotional reasons, the share price of KPT clearly indicates it is not useful for these reasons. Rather it is for that oft overlooked component of the role of public-company CEO, whereby assisting shareholders truly understanding the industry in which they invest, which should ultimately serve to the long-term benefit of the company as they acquire a group of shareholders who truly understand the business and are able to avoid panic when the inevitable slings and arrows that accompany every industry arrive.

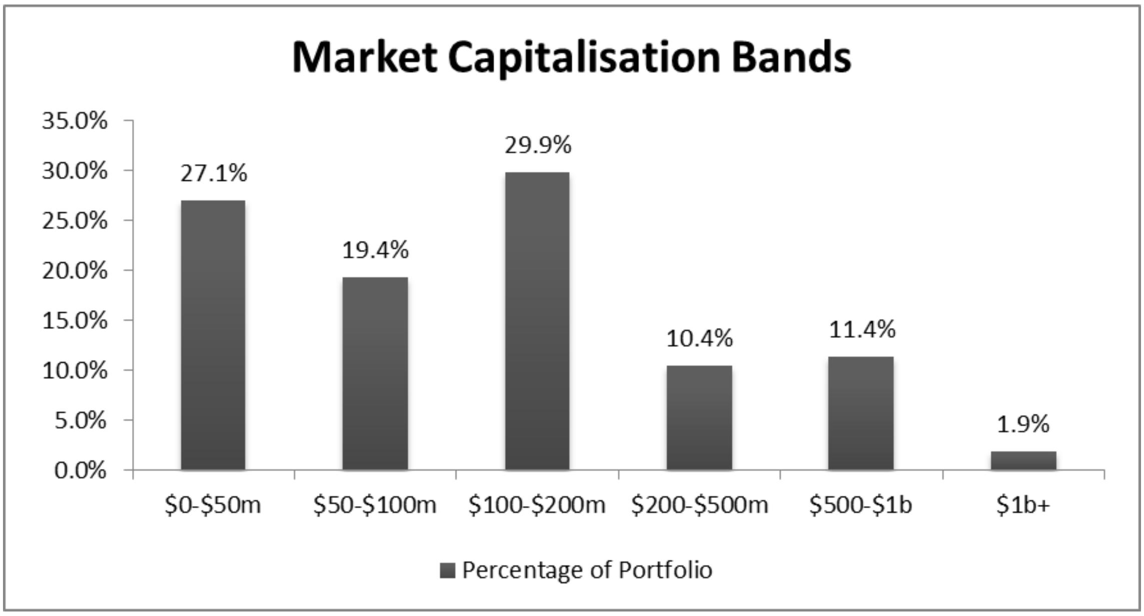
Key Portfolio Information:-

Our top 10 holdings at 31 July 2018 were:

Rank	Holding	Percentage Equity Weighting	Percentage Portfolio Weighting
1	United Overseas Australia (UOS.ASX)	11.4%	9.5%
2	Kangaroo Plantation (KPT.ASX)	8.4%	7.1%
3	Global Construction Services (GCS.ASX)	6.3%	5.3%
4	APN Regional Property (APR.NSX)	5.4%	4.5%
5	Undisclosed	4.6%	3.9%
6	Blackwall Limited (BWF.ASX)	4.4%	3.7%
7	Locality Planning (LPE.ASX)	4.2%	3.6%
8	Undisclosed	3.4%	2.9%
9	Undisclosed	3.3%	2.7%
10	Dicker Data (DDR.ASX)	2.8%	2.4%

Our largest 5 holdings now comprise 36.1% of our invested capital, our top 10 holdings are 54.2% and our top 15 represent 67.0%. Cash and cash equivalents are 15.9% of the portfolio.

The market capitalisation graph is set out below. This month, the median market capitalisation is $101.6m.



As always, investors with any questions, suggestions, comments or investment ideas should feel free to drop me a line – Tony@egpcapital.com.au

Fund Features		Portfolio Analytics	
Min. initial investment	$100,000	Sharpe Ratio[1]	0.39
Additional investments	$5,000 (Minimum) $200,000 (Maximum)	Sortino Ratio[1]	0.17
Applications/redemptions	Monthly	Annualised Standard Dev. – EGP Annualised S/D - Benchmark	6.77% 7.48%
Distribution	Annual 30th June	Largest Monthly Loss – EGP Largest Monthly Loss - Benchmark	-3.0% -3.8%
Management fee	0%	Largest Drawdown – EGP Largest Drawdown - Benchmark	-7.4% -3.8%
Performance fee (<$50m) Performance fee (>$50m)	20.5% (inc GST) 15.375% (inc GST)	% Of Positive Months – EGP % Of Positive Months - Benchmark	56.5% 65.2%
Auditor	Ernst & Young	Cumulative return[2] – EGP Cumulative return[2] – Benchmark	4.2% 13.7%
Custodian/PB	NAB Asset Services	1 year return[2] – EGP 1 year return – Benchmark	N/A N/A
Responsible Entity	Fundhost Limited	3 year annualised return[2] – EGP 3 year annualised – Benchmark	N/A N/A
Fund Size	$56.7m	5 year annualised return[2] – EGP 5 year annualised – Benchmark	N/A N/A
Mid-Price for EGPCVF Units Accumulated Franking per Unit	$1.0025 $0.0000	Buy Price for EGPCVF Units Sell Price for EGPCVF Units	$1.0040 $1.0010

1 Sharpe and Sortino Ratios calculated using the Monthly Benchmark ASX200 Total Return Index

2 Return is net of all fees and costs and assumes reinvestment of dividends. 1, 3 and 5 year figures are rolling annualised figures.

Past performance is not an indicator of future performance.

The information in the below table is provided for shareholders in EGP Fund No. 1, and does not relate to the EGPCV Fund.

EGP Fund No. 1 Pty Ltd Equivalent Price	$2.0535
EGP Fund No. 1 Pty Ltd Franking Credits	$0.0109