Conscious Investor® Fund
Interim Letter to Members: July 2014 – December 2014

The Start of Warren Buffett's Investing Career: What can we learn from it?

As you know, wherever possible we aim to follow the investing principles of Warren Buffett as we build the Conscious Investor Fund®. For this reason I have been re-reading letters written by Buffett to investors in his original Buffett Partnerships to see if there is anything more we could be doing. I thought you might like to know some of the highlights of these letters and how we are trying to implement them in the Fund. It is also interesting to see some of the key points in Buffett's earlier life that prepared him to be the investor he is today.

Early Years with Benjamin Graham

Warren Buffett's career as a value investor dates from around 1950 when he read Benjamin Graham's *Security Analysis* and *The Intelligent Investor*. After getting turned down by Harvard, Buffett decided to go to Columbia University for a Master of Economics degree. A big part of his choice was because Graham was on the Columbia Business School Faculty teaching a part-time course in investing with David Dodd, an associate dean in charge of admissions.

The book *Security Analysis* was actually written by Ben Graham and David Dodd although it is recognised that it is really all Graham's ideas. At Columbia they taught a course called "Investment management and security analysis" based on their book. Even before the course, Buffett knew this book intimately recalling: "I could quote from any part of it. At that time, literally, almost in those seven or eight hundred pages, I knew every example. I had sopped it up."

It seems that Buffett was Graham's best student and the only one who was ever given an A+ grade. He said to Graham that he would like to work for him in the Graham-Neumann Partnerships in New

York. Ben turned him down explaining that Jews were discriminated against on Wall Street and he wanted to try to help his fellow Jews by giving them the few jobs available at Graham-Neumann. Buffett was very disappointed. (Buffett has often quipped that Graham had perfectly calculated his true intrinsic value at the time and he came up short.) Buffett returned to Omaha and became a stock broker - something he never enjoyed.

A couple of years later Graham called and told him there was an opening. Buffett immediately went to New York with his family without asking Ben anything about salary or compensation. He worked at Graham-Neumann for 2 years and, when Ben decided to wind down the partnership, he returned to Omaha and started his first Buffett Partnership in 1956.

"He looked like he was eighteen"

Buffett started his partnerships by encouraging family members and anyone else who would listen to invest with him. One difficulty was that he was only 26 but looked and acted even younger. An early investor, Edwin Davis, a prominent Omaha urologist, recalled his first meeting with Buffett one Sunday afternoon:

> The doorbell rang and in comes this guy—egad—he looked like he was eighteen. He had very short hair, almost a butch. His collar was open, his coat was too big for him. Everybody noticed it. He talked so very fast.

Buffett laid out the ground rules. The Davises could only add or withdraw money in one day of the year, December 31. He also told them that on that day they would receive a general summary of the results. Otherwise, he warned them, he would not disclose anything about how he was investing their money. Right from the start, Buffett believed in the importance of secrecy.

The Davises, as limited partners, would get all the profits that Buffett could earn up to 4 percent.[1] After that they would share the remaining profits—75 percent to the Davises and 25 percent to Buffett. They liked what they heard and put in $100,000. In this way Buffett gathered more investors and set up more partnerships. But not everyone agreed with his requirements with many stories of families in Omaha who turned him down. In some case, Buffett also turned them down because he wasn't satisfied that they fully accepted his conditions.

The Partnerships and the Letters

Buffett ran his Partnerships from 1956-1969. The partnerships started with eight investors putting in a total of $105,000 and Buffett investing $100.

1956: By the end of 1956, Buffett had five small partnerships running with $500,000 invested in all of them combined. Buffett had a liquid net worth of $140,000.

1962: By the end of 1962 he had $7.2 million under management. Of this, $1 Million was Buffett's money. He had 90 investors at this time—up from the original 7. He merged all the individual partnerships into one in 1962 and moved out of his home into Kiewit Plaza - the location that today serves as Berkshire Hathaway headquarters. Warren made his first investment in Berkshire

[1] Later Buffett raised the cut-off from 4 percent to 6 percent.

Hathaway in 1962 at $7.50 per share. At the time Berkshire was 100 percent in textile manufacturing—men's suit liners to be precise.

1966: By the mid-sixties, Buffett was finding it increasingly difficult to find value in the markets. In early 1966, he closed the partnership to new partners.

1967: Buffett informed his partners that some of the new mutual funds had better results than his. He also told them that his stream of new ideas was down to a trickle. His perspectives were diametrically opposed to Wall Street's. The markets were climbing; there was lots of optimism and euphoria in the air. In 1966 and 1967, Buffett bought his first 100%-owned private businesses for the partnership, two retailers for a total of $15 million. Towards the end of 1967, the partnership had $65 Million in assets.

In the 1967 letter Buffett also starts to talk about the consequences of him not being as "hungry" as he used to be and the difficulty of finding good investment opportunities:

> The results of the first ten years have absolutely no chance of being duplicated or even remotely approximated during the next decade. They may well be achieved by some hungry twenty-five year old working with $105,100 initial partnership capital and operating during a ten year business and market environment which is frequently conducive to successful implementation of his investment philosophy.
>
> They will not be achieved by a better fed thirty-six year old working with our $54,065,345 current partnership capital who presently finds perhaps one-fifth to one-tenth as many really good ideas as previously to implement his investment philosophy.

1968: Assets under management increased by 59% to $104 Million. He beat the Dow by over 50%. 1968 turned out to be Buffet's best year. He was, however, finding it very very difficult to find great investment ideas in the overheated bull market. Buffett had amassed $25 million for himself over the preceding 13 years.

1969: In May 1969, Buffett stunned his partners with the news that he was liquidating the Buffett Partnership. Although perhaps this was foreshadowed by his earlier statement about the difficulty of finding new ideas. He offered two suggestions to his limited partners regarding how they might invest the proceeds. Buffett gave them the name of the Sequoia Fund (www.sequoiafund.com), which was being setup by his former classmate Bill Ruane. The partnership liquidated all but two of its investments: Berkshire Hathaway and Diversified Retailing. Thus, each partner could take their proportional stake in stock of these two entities or opt to cash out. Buffett would take the stock. At the time, Buffett encouraged his limited partners to take stock with the following statement:

"I think both securities should be very decent long-term holdings and I am happy to have a substantial portion of my net worth invested in them."

Thus ended the era of the Buffett Partnerships with the associated letters and began the era of Berkshire Hathaway.

Work-Outs, Control Situations and Secrecy

I would like to describe three points in Buffett's letters which I think standout: work-outs, control situations and secrecy.

Work-Outs

Buffett broke his partnership portfolios into three categories which he called Undervalued Securities (or generals), Work-outs and Control Situations. The concept of the first category is straightforward. But, unsurprisingly, Buffett, has a number of important insights. I will write about this category in the next newsletter

Regarding work-outs, in his 1957 annual letter he wrote:

> A work-out is an investment which is dependent on a specific corporate action for its profit rather than a general advance in the price of the stock as in the case of undervalued situations. Work-outs come about through: sales, mergers, liquidations, tenders, etc. In each case, the risk is that something will upset the applecart and cause the abandonment of the planned action, not that the economic picture will deteriorate and stocks decline generally.

Today, just as back in 1957, we have "sales, mergers, liquidations, tenders, etc.". However, I think the difference between the present situation and back in the 1950s is twofold: (1) stricter rules and laws against taking advantage of inside information, and (2) more availability and faster dissemination of information.

Looking at the early writings of Benjamin Graham it is quite clear that who you knew was an important means of getting information about future corporate activities and that it was possible to take advantage of this information, something that is strictly prohibited these days. In particular, today there are strict requirements about continuous disclosure. For example, ASX rules asserts that once a listed company becomes aware of any information "that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information." ASIC have similar requirements with strict penalties for any public company failing to provide continuous disclosure of sensitive information. Basically, either all outsiders have to know or none.

So these rules against inside information make the likelihood of being able to plane a strategy based on information regarding "sales, mergers, liquidations, tenders, etc."

Of course, owning shares in an undervalued company, particularly one in a competitive area, increases the likelihood of it being bought for a healthy profit. This was the case last year with Wotif when it was acquired by Expedia with a premium of 25%. But this is more a case of "fortune favouring the prepared" (to slightly adjust a quote by Louis Pasteur), than a definite strategy.

Control Situations

In his 1962 Letter to investors Buffett wrote that a control situation is where:

> We either control the company or take a very large position and attempt to influence policies of the company. Such operations should definitely be measured on the basis of several years. In a given year, they may produce nothing as it is usually to our advantage to have the stock be stagnant market-wise for a long period while we are acquiring it.

He then wrote:

> We are presently involved in the control of Dempster Mill Manufacturing Company of Beatrice, Nebraska. Our first stock was purchased as a generally undervalued security five years ago. A block later became available, and I went on the Board about four years ago. In August 1961, we obtained majority control, which is indicative of the fact that many of our operations are not exactly of the "overnight" variety. Presently we own 70% of the stock of Dempster with another 10% held by a few associates.

Of course, Buffett's most famous "control" situation was Berkshire Hathaway. He started buying shares in the company in 1962 but it was not until his 1965 letter that he announced that "the partnership owns a controlling interest in Berkshire Hathaway Inc., a publicly-traded security."

Teaminvest Private At present the Conscious Investor® Fund is much too small to follow Buffett by considering gaining control of any listed company. However, there is a situation where we can have more control and possibly a seat on the board, and that is through taking a position in suitable companies via Teaminvest Private (TIP).

Typically members of TIP interested in a particular company would collectively have a 50% equity position in the chosen company. The due diligence process used to evaluate companies for TIP is extraordinarily thorough.

The Conscious Investor® Fund is hoping to become a member of TIP and take advantage, as well as contribute to, this evaluation process. If there are any suitable opportunities, we will look to invest in them. Investing in suitable private companies (as well as selected overseas companies), is a unique opportunity for the Fund and makes it more like a mini-Berkshire Hathaway with positions similar to Buffett's "control" situations.

Even though the Fund's mandate allows us to invest in private companies, we are still working through the appropriate legal steps. Of course, nothing will be done in rush.

You can read more about Teaminvest Private on their website www.teaminvest.com.au. Or please contact us if you would like more details.

Secrecy

A strong theme throughout Buffett's letters to his investors is that of secrecy. He would only talk about a few of the companies he was investing in, and never about any of the companies where he was trying to build a control position. For example, he was buying shares in Berkshire Hathaway for three years before he announced it.

In the report **An Owner's Manual** written for shareholders in Berkshire Hathaway, Buffett writes:

> Despite our policy of candor, we will discuss our activities in marketable securities only to the extent legally required. Good investment ideas are rare, valuable and subject to competitive appropriation just as good product or business acquisition ideas are. Therefore we normally will not talk about our investment ideas. This ban extends even to securities we have sold (because we may purchase them again) and to stocks we are incorrectly rumored to be buying. If we deny those reports but say "no comment" on other occasions, the no-comments become confirmation.

As you will be aware, we do let our members know the names of the largest 10 holdings. (See the next section.) But there may come a time when we reduce this number if there seems a clear advantage to do so.

Extra Investments into the Fund

During the past 12 months two Fund members added to their holdings: we appreciate this sign of confidence. In my own case, I am reorganising my investment portfolios at the moment and plan to add another $100,000 through my superannuation fund in the next month.

One advantage of increasing your holding is that once it gets above $450,000, there is no increase in the monthly fees.

Role and Performance of Largest Holdings

The Conscious Capital Fund is a boutique fund that will remain small and true to its principles rather than include companies that do not satisfy its stringent requirements. The recommended period for investing in the Fund is 5 years or more to allow for the future success of the companies held by the Fund to be reflected in share prices and dividends.

The companies below make up the largest ten of the Fund. No businesses stay the same. Yet we feel that these businesses are such that they will be very similar in five and ten years' time but with greatly expanded sales and earnings.

The Capital Allocation Team decided that these companies could make up to around 60 percent of the fund. Currently they are at the 60.7 percent level.

The following table shows the average eps growth over the past five years, the dividend yield, total outlay for each of the companies and the total value at the end of December as measured by the market value and cash dividends over the holding periods of this core ten.

Shares	Name	EPS Growth 5 Yrs	Div Yld (1)	Total Outlay (2)	Value 30 June 2014 (3)
7,450	CSL Limited	11.16%	1.6%	$508,150	$652,069
11,000	Ramsay Health Care	17.18%	1.6%	$479,585	$638,194
17,000	Woolworths Limited	5.81%	4.7%	$594,408	$552,334
19,900	Domino Pizza Enterpr	19.96%	1.7%	$186,101	$517,108
5,600	Commonwealth Bank.	10.28%	4.8%	$424,523	$503,900
13,500	Flight Centre Travel	20.98%	4.5%	$633,543	$461,227
10,221	Wesfarmers Limited	5.36%	4.8%	$427,783	$452,949
36,278	ARB Corporation	10.12%	2.6%	$419,543	$481,258
55,000	Super Ret Rep Ltd	15.95%	5.3%	$590,790	$417,411
100,000	My Net Fone Limited	76.65%	1.5%	$222,518	$369,571
	Subtotal			$4,486,944	$5,046,021
	Other Companies			$2,818,171	$2,818,171
	Total			$6,900,240	$6,900,240

(1) The dividend yield assumes that the shares were held for a full 12 months. It does not include franking credits.

(2) The Total Outlay is the total amount paid for the position in each company starting in March 2013 up to the end of December 2014. The outlay is adjusted for any profits or losses from sales.

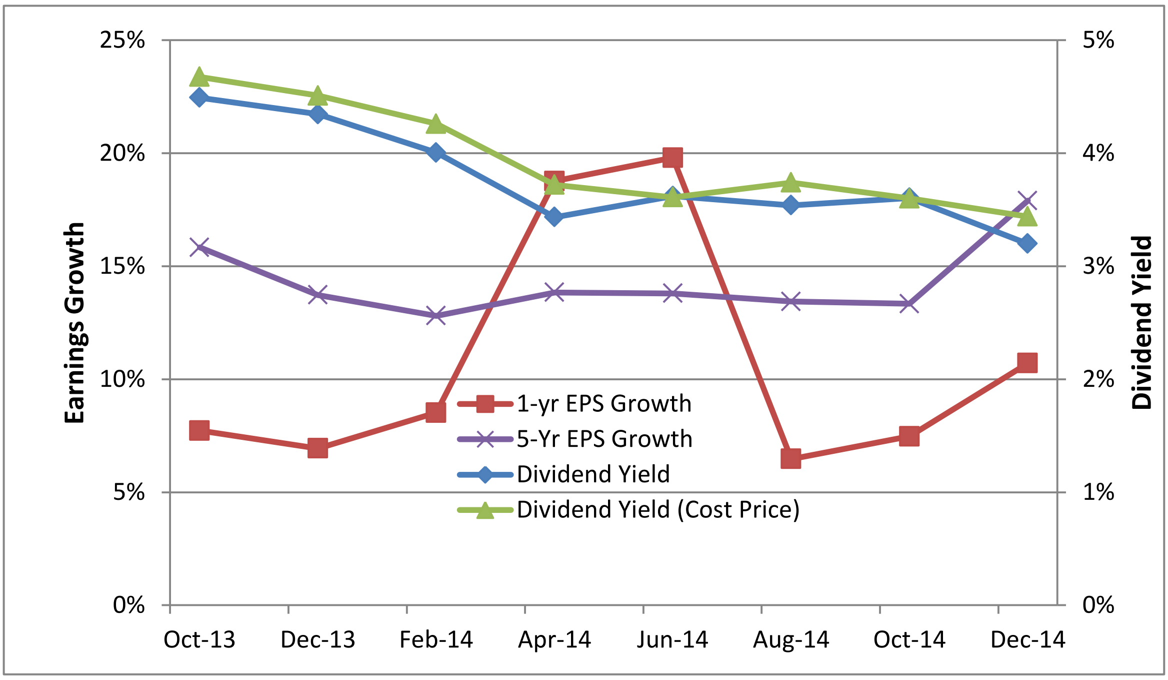
(3) The Value column includes receipts from cash dividends over the lives of the holdings. The dividends do not include franking credits.

The average dividend yield for these companies is 3.3 percent. To date the Fund has collected $346,640 in dividends (or $488,226 including franking credits). Some members have asked to receive the dividends each quarter while others prefer that they be used to purchase more units.

Tracking Earnings per Share Growth and Dividend Yield

For Fund performance we want earnings per share (EPS) of the chosen companies to be growing each year. A guide whether this is likely to take place is by looking at the average growth of EPS over their recent history. So it makes sense to search for companies that are likely to grow their EPS in the future amongst companies that have already achieved this in the past.

For this reason we like to track the average growth rate of EPS for the core companies in the Fund. Similarly we like to track the average dividend yield of these companies.



In the preceding chart, the first two lines (with the scale on the left) show the history of the average growth of earnings per share for the largest ten holdings in the Fund, the core companies. The growth rates of the individual companies are weighted according to their proportion within the Fund. Everything is recalculated at the end of each two months, including which are the core companies.

Our key goal is to choose those companies with strong historical earnings per share growth and with the highest likelihood of this growth continuing in the future as they have in the past.

The second two lines (with the scale on the right) show the average dividend yield for the largest ten holdings in the Fund. In the first case the dividend yield of each company is calculated using the price at the time of the calculation. In the second case it is calculated using the cost price of the individual companies.

Conscious Investor® and the Teaminvest Methodology

The investment process used by the Capital Allocation Team for the Fund consists of four steps: Filtering using Conscious Investor®; Applying the Teaminvest investment methodology; Calculating the price to pay and when to sell; and a Final Checklist. Full details of these steps are contained in the Information Memorandum. Here we just give a brief summary of the first two steps.

Conscious Investor® filters and analyses all companies listed on the ASX in three steps: Filter, Research and Return. The main components of the filter stage zero in on companies with attributes such as strong and stable growth in earnings and sales, high and consistent return on equity and not too much debt. The research stage helps to limit the results to companies for which these attributes are likely to continue. Finally, the return stage calculates what maximum price to pay to be confident about getting the required rate of return over the long term. It uses automatic margin-of-safety calculations based on stress testing the investment assumptions.

The Teaminvest Methodology focuses on the following four areas. Wherever possible the Capital Allocation Team scores the areas to increase the precision of the decision process.

- How does the company make money? What is the business of the company? Who are its customers?
- Investments should be like castles with deep moats: What are unique features of the business that separate it from its competitors? These “economic moats” are scored in terms of depth and durability.
- Risks need to be identified: All businesses face risks that could weaken the continuing success of their operations. These risks are identified and are scored according to the likelihood of their occurring over the next economic cycle and their potential damage if they do.
- Is management honest, open and rational? As part of examining the business, evaluation is made whether or not it is believed that the board and senior management are acting honestly, rationally and in the best interests of shareholders. Specific areas that are looked at include the number and type of related party transactions and the remuneration structure for the CEO and senior management. The Capital Allocation Team scores remuneration in terms of clarity, alignment and quantum.

On behalf of the Capital Allocation Team,

Warm regards,

John Price

The Capital Allocation Team prepared this report for members of the Conscious Investor® Fund. It does not take into account anyone’s personal circumstances. Remember, what happened in the past is not always what will happen in the future.

Questions? Contact us:

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