Conscious Investor® Fund
Interim Letter to Members: December 2015

Growth in Sales and Earning

An important statement by Warren Buffett is:

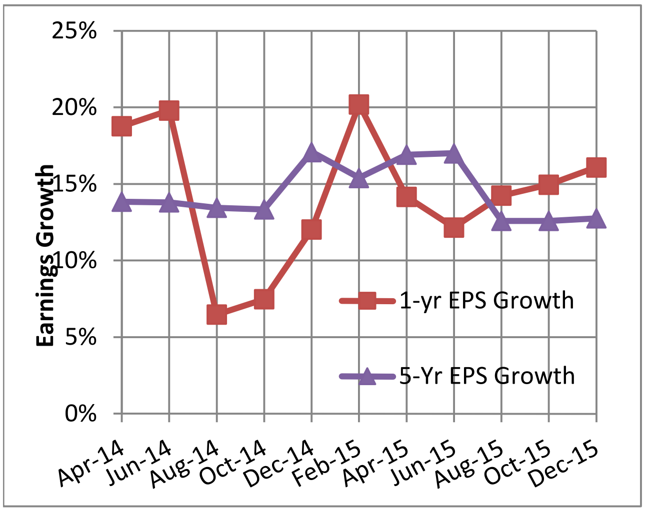
> *Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards - so when you see one that qualifies, you should buy a meaningful amount of stock. You must also resist the temptation to stray from your guidelines: If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.*
>
> *Though it's seldom recognized, this is the exact approach that has produced gains for Berkshire shareholders: Our look-through earnings have grown at a good clip over the years, and our stock price has risen correspondingly. Had those gains in earnings not materialized, there would have been little increase in Berkshire's value.*

It is this statement that leads to a central goal of the Capital Allocation Team: to make sure that, as we move forward, the average of the earnings per share over all the companies in the portfolio grow, as Buffett said, at a "good clip". When combined with the dividends, most years this growth of EPS should translate into a healthy performance for the Fund. But there will be years when this does not happen resulting in mediocre performance even though the average sales and earnings continue to grow. Often this will be a chance to invest further in the great companies that the Fund already holds.

The adjacent chart shows the average history of the growth of earnings per share of companies in the Fund over 5 years and 1 year. Even though these are historical results, research shows that having strong and stable growth histories makes it more likely that this growth will continue.

The chart shows that for the 12 months ending December 2015 the average earnings per share of companies in the Fund grew by 16.08 percent.

The good news is that this growth translated well into Fund performance for the year.



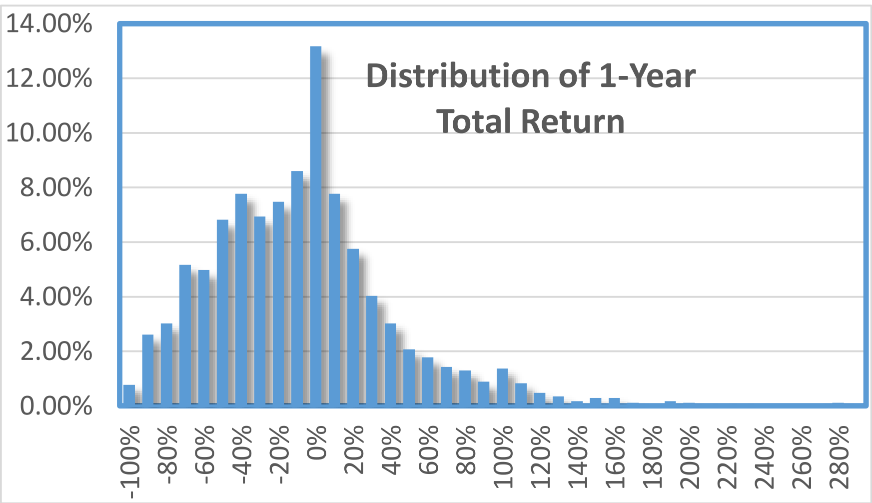
For the calendar year 2015 growth in earnings per share and dividends resulted in actual portfolios of Fund members growing by 22.84 percent assuming that dividends were reinvested. This compares to 2.35 percent for the S&P / ASX Accumulation Index.

Profiting from Avoiding Capital Killers™

It is easy to get drawn into thinking that investing is all about picking companies that have outstanding share price performance. Of course, in the end, it is important to have the majority of companies that have share prices that grow over time. And, as just explained, we look for this to happen by choosing companies that have healthy growth in earnings per share over an economic cycle. What we call Wealth Winners®.

But there is another side to investing that is just as important, namely avoiding companies that are Capital Killers™.

The next chart shows the distribution of the performance or total return of almost 2,000 companies on the ASX over the past year. (The data includes capital gains and dividends.)



Notice the bulge in the percentages of companies that had negative performance. Almost one-third of the companies would have lost 30 percent of your capital or more if you had bought them. In other words, if you outlaid $1,000, at the end of the year you would have less than $700 including dividends.

Let's look at this another way. If you had invested across the whole market, you would have got a total return of 2.5 percent for the year. But if you avoided Capital Killers™ (companies with a performance of negative 30 percent or worse) but the rest of your portfolio remained the same, you would have topped 29.3%.

What this means is that successful investing is more about avoiding companies that are likely to have poor share price performance, Capital Killers™, than about picking Wealth Winners®. When we do that, high portfolio performance follows.

As Warren Buffett said over 30 years ago, the first two rules of investing are:

Rule #1: Never lose money

Rule #2: Never forget rule #1

The problem is that Buffett did not explain how to implement these rules. In the next sections I will explain two ways that we do this in the Fund using recent research to demonstrate their effectiveness. (I have done this type of research many times in Australia and the US. But I still repeat it from time to time to make sure that nothing has changed.)

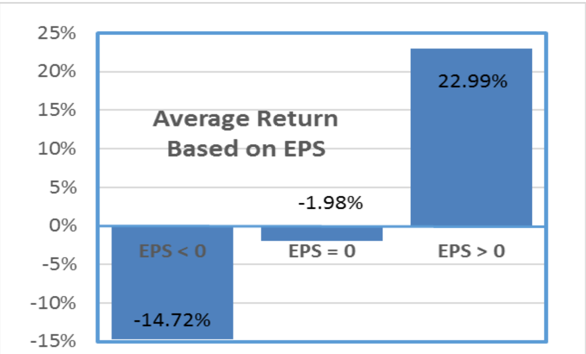
Companies Must Be Profitable

Further research I did shows that the first step in implementing Buffett's rules are to ensure that the companies in the Fund are profitable as businesses. In other words, the Fund needs to invest in companies that, as businesses, do not lose money.

As explained earlier, we want companies with growing earnings. But even just making sure that the companies are profitable is a considerable advantage.

In any year, just one-third of companies on the ASX make money. The rest of the companies are equally spread between those that either lose money or make zero money. In terms of share price performance, there is a huge difference between these three groups of companies.

The adjacent chart shows that the average total return for companies in three categories based on earnings per share over the past 12 months: those that lost money (EPS < 0), those that made zero money and those that made money. The average total return for those that had positive earnings per share was 22.99 percent over the past 12 months compared to a loss of negative 14.72 percent for those that lost money. Even the average return for those with zero EPS was a loss of negative 1.98 percent.



Companies Must Not Be Overloaded With Debt

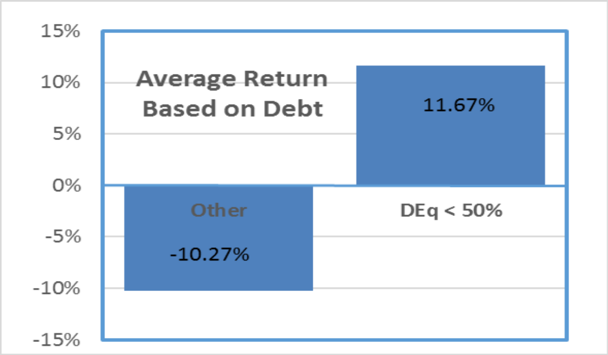
Most public companies have debt. In some cases, though, the debt is so high that the smallest difficulty can send the company crashing down, and even out of existence.

Consider Babcock and Brown (BNB), for years the darling of the financial press. Not many knew, or took any notice of, the fact that it had a debt to equity ratio of over 450 percent meaning that for every dollar of equity, the company owed more than $4.50. In round figures, BNB had equity of $2.5 billion and owed $11.6 billion in interest-bearing debt. How much interest? During 2007 the company paid an interest bill of $505 million from its revenues of approximately $2 billion. Bonuses paid to management came to another $573 million, but that is another story.

Putting it simply, it was an accident waiting to happen. As soon as there was any tightening of general credit, let alone the global financial crisis, the company would suffer badly. Sure enough, this is what happened. From a high of around $35.00, the shares crashed to $0.14 before being delisted in June 2009.

Apart from the danger of high debt levels, too much debt may mean that the company is not able to move quickly and take advantage of any favourable acquisition opportunities.

High debt means it is more likely that the company will end up being a Capital Killer™. And even if it is not a Capital Killer, as the chart shows, companies with a limited amount of debt (say, less than 50 percent debt to equity) on average far outperform the rest of the market, 11.67 percent compared to negative 10.27 percent.



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? Are we confident that there will be need for their products and services in five to ten years?
- 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, an evaluation is made as to whether we believe 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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