Conscious Investor® Fund
Interim Letter to Members: December 2016

Earnings During 2016

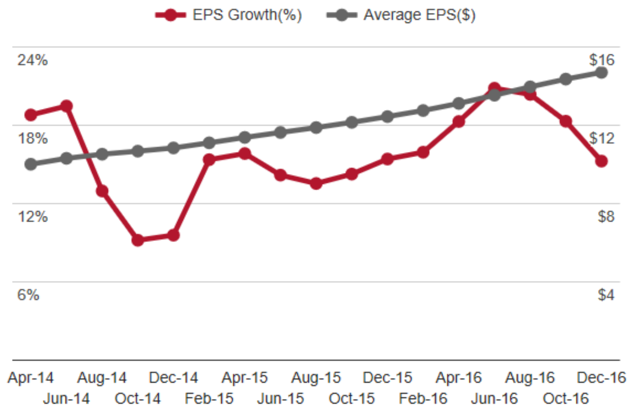
During 2016 the average[1] of the growth of earnings per share for the companies in the Fund grew at the steady clip of 15.2% over the previous 12 months. Over time, provided this growth is maintained, this should translate into healthy growth of dividends and share price.

Two standouts were Ramsay Healthcare and Domino's Pizza. Their EPS grew by 20.4% and 46.1% during 2016.

Similarly, the weighted average ROE was a robust 27.9%. In other words, at the end of December 2016, managers of the companies in the portfolio had earned an average of 27.9% on the equity in their companies. Again, overtime, if this ROE is maintained, it will translate into strong growth of share prices.

The measure of how growth of earnings translates into the growth of share price is via the price to earnings ratio (P/E ratio). The weighted average P/E ratio was 19.0, about what would be expected given the overall high quality of companies in the portfolio. (See the regular EPS reports for more details.)

The adjacent chart shows the month-by-month growth of the average earnings per share for companies in the Conscious Investor Fund from April 2014 to November 2016. It also shows the month-by-month average annual growth of EPS over the same period



Translation into Share Price

Despite the continuing growth of average earnings per share, over 2016 this overall growth has not yet translated into growth of share prices and hence into increase of the Unit Price. Over the 11 months from January 2016 to November 2016, the Unit Price grew by 4.1%. Of course, as earnings continue growing at past rates, we expect Mr Market to eventually wake up with the share prices, and hence Unit Prices, growing at rates similar to that of earnings.

[1] Averages over the portfolio are calculated by including all the companies in the portfolio at the end of December 2016. Each company is weighted in the average by the percentage of the portfolio made up by the equity of each company. Note that this average may include companies that have not been held for all of 2016.

In the past few months three of our major holdings have disappointed in the short term. In each case, they made announcements that their future immediate earnings are not going to be as high as in the past corresponding periods. These announcements caused a sharp drop in the share prices of the companies. On the brighter side, in each case, there were plenty of indicators that these will only be temporary slow-downs in the growth trajectories of their earnings.

The three companies are Flight Centre, Blackmores and Sirtex. Instead of focussing on the many successes in the Fund, I thought I would write about these three companies.

Flight Centre Travel Group (FLT): On 4 November 2016, FLT announced that they expect FY17 underlying profit before tax (PBT) to finish between $320 million and $355 million compared to $352.4 million for FY16. Assuming this translates into EPS, this means that EPS will change from between -8.5% and +0.7%.

Yet, this caused a large drop of 12-15% over the period of the announcement on top of a drop of over 25% in the preceding months.

On the other side, the company also reported that it has an exceptionally strong balance sheet, a diverse stable of strong brands around the world, and a clear strategic blueprint for the short-term (FY17), the medium term (2022) and the long-term (2035).

A particular strength of Flight Centre is its management team headed by the company’s founder, Graeme ‘Skroo’ Turner. The company has been at the forefront of the travel industry since Turner and his friend, Geoff ‘Spy’ Lomas, bought a double-decker bus in Yorkshire in order to run tours in Europe. In 1973 they ran their first tour, six-weeks travelling through Spain, Portugal and Morocco.

Repeatedly Turner and his team have adapted to and mastered changes in the travel industry to make Flight Centre one of the world’s most successful travel companies. The fact that Turner holds 15 million shares in the company and that executives and staff are helped to purchase shares in the company is probably a factor in this.

Apart from its main brand Flight Centre, it has over 40 other brands including Escape Travel, Student Flights, Travel Associates, Cruiseabout, Liberty Travel, Infinity Holidays, GOGO Vacations, FCm Travel Solutions, Corporate Traveller, Stage and Screen’ cievents and Campus Travel.

The company employs more than 19,000 people globally and has twice been judged Australia’s best employer, in addition to claiming a number of other employer and travel agency awards in Australia and overseas. From an investors’ perspective, the company has a record of being very careful with its spending and for creating value for its shareholders.

Blackmores (BKL): On 24 August 2016, BKL announced that some retailers were destocking and some exporters were changing the channels through which they acquire products. Because of this, they thought that first quarter results would be down compared to the prior corresponding period. This caused the share price to drop by 30%. As foreshadowed, as part of the announcement of the first quarter results, on 27 October the company announced that net profit after tax was $12 million, down 46.6% on the PCP. Over 2016, the share price halved from a record high of $220.

Yet, the board believes that the stocking issues are short-term problems writing that it "remains confident in the Group's strategic focus and long-term prospects".

Blackmores is similar to Flight Centre in that it also has a strong owner orientation. The chairman, Marcus Blackmore, son of the founder Maurice Blackmore, has set a focus in the company on natural health and inspiring people to take control of and invest in their health and wellbeing. This vision is shared by its employees with one quarter holding a healthcare qualification. Also, more than half the staff speak an Asian language as their mother tongue. This is significant given the growth of the company into China. As well, in September the company announced that it has partnered with Kalbe, a major supplier of pharmaceutical products in Indonesia with an institute to train people in natural health care products. Christine Holgate stated: "We will be launching with eight products and have 25 products by the end of the year."

Marcus Blackmore has over 4 million shares and the CEO, Christine Holgate, has almost 50,000 shares. It is the type of company that is likely to continue to grow its earnings year after year.

Sirtex Medical Limited: SRX is an Australian company with an approved cancer treatment supplied globally. Sirtex's main commercialised product is a targeted radioactive treatment for liver cancer called SIR-Spheres® Y-90 resin microspheres.

Since it started, the company has supplied approximately 67,000 doses of SIR-Spheres Y-90 resin microspheres to treat liver cancer patients in over 1000 medical centres in over 40 countries. Even so, these doses represent only two per cent of the total addressable market.

In the annual report for FY16 the company reported:

- 12 consecutive years of growth
- Record dose sales of 11,931, up 16.4%
- Record revenues of $232.5 million, up 32.0%
- Net profit after tax of $53.6 million, up 32.8%
- Cash balance of $107.0 million, up 44.7% and no debt
- Earnings per share of 93.7 cents, up 31.3%
- Dividend Per share of 30.0 cents, up 50.0% per cent

On 25 October, the company announced that it anticipated "double digit dose sales growth will continue in FY17." Several weeks later, on 9 December, the company revised this estimate stating that dose sales growth is anticipated to be in the order of 5-11% for the year and 4-6% in the first half. The report continued that EBITDA is anticipated to be positive in the 2017 financial year but could be between a drop of 12% and no change on the previous year

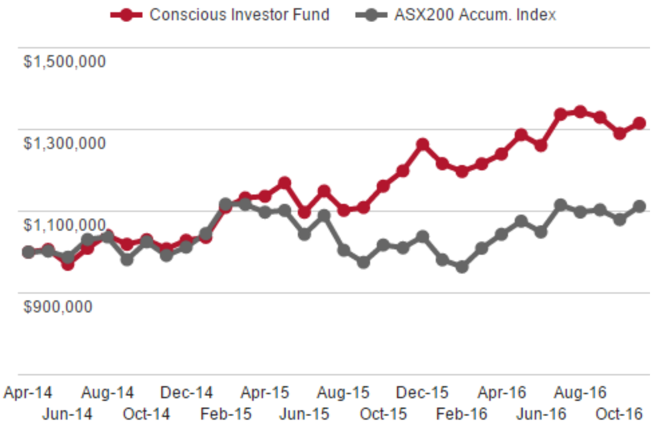
This announcement caused a drop of approximately 50% in the share price.

On 9 January 2017, the company announced that dose sales of SIR-Spheres Y-90 resin microspheres for 6 months ending 31 December increased by 5.6%, the upper end of the earlier guidance, a good sign for the future.

Despite these short-term uncertainties, Sirtex looks as if it will be able to grow its earnings over time.

Fund Performance

The adjacent chart shows the dollar performance of the Fund after success fees from April 2014 to November 2016 compared to the S&P/ASX 200 accumulation index. Over this period, an investment of $1 million dollars would have grown to $1,315,264 compared to $1,111,839 for the Accumulation Index. In percentages, the average annual growth of the Fund was 11.48% compared to 4.29% for the Accumulation Index.



Johnny Looking Down and Nike

I recall as a child reading a story (or was it a poem?) about a little boy called Johnny Looking Down. If you saw me over the past few months you might think that this would be an appropriate name for me. I walk around looking at peoples' footwear, particularly checking what percentage are wearing Nike's.

Three reasons for this. First, by any standard it is an extraordinary company. Co-founded by Bill Bowerman and Phil Knight in January 1964, as Blue Ribbon Sports, it officially became Nike in May 30, 1971. The company takes its name from Nike, the Greek goddess of victory. Today Nike employs over 70,000 people and has annual sales of around US$15 billion. It has 142 footwear factories located in 15 countries. And 394 apparel factories located in 39 countries.

Nike prides itself in being the leader in shoes and apparel for sports. For example, recently it released the so-called AeroReact shirts which change their breathability depending on the athlete's temperature. The company has just released shoes, HyperAdapt, which lace themselves so that they have an optimal fit at all stages of competition and use.

Nike is also a leader in manufacturing technology. One technological innovation is the so-called Nike Flyknit, a new way of making a shoe upper by knitting or stitching threads and strands to shape and form the upper with computer-controlled precision. This replaces the standard shoe-making technique of stamping out patterns of uppers in a piece of fabric, which requires cutting and sewing, resulting in a lot of wasted, unused scraps.

According to Nike's own estimates, "Flyknit reduces waste by about 60% on average compared to cut and sew footwear, and through spring 2016, has reduced nearly 3.5 million pounds of waste since 2012." This has direct implications on the company's product cost savings. During the four years since 2012 when Nike first introduced Flyknit, the rate of increase for its cost of revenue trailed the revenue growth rate each year, contributing to the company's continued expansion on gross margin, which was 46.24% at the end of fiscal 2016.

Second, although not in the top ten, the Fund now has quite a large position in the company.

Just Do It

Third, I have just finished reading *Shoe Dog: A Memoir by the Creator of Nike* by Phil Knight. It is an astounding story of how Knight overcame huge odds. During his MBA at Stanford, he wrote a study on the possibility of starting a business in the USA importing running shoes. A few years later, in 1962, he bluffed his way into a contract with a Japanese manufacture of running shoes. He had no company and no money, borrowing $50 from his father for the first trial shipment. In his first meeting with the Japanese manufacturer, Knight had to come up with the name of a company. On the spur of the moment he blurted that his company was Blue Ribbon Sports, later changed to Nike.

For years, every month bought a new problem, often associated with persuading the local bank to keep funding rapidly expanding imports. "Grow or die, that's what I believed, no matter the situation… So I was forever pushing my conservative bankers to the brink" wrote Knight.

It wasn't until 1980 when the company was manufacturing its own shoes and had floated was its future more certain. Even now, Knight remains the Emeritus Chairmen and regularly attends his office in Nike headquarters.

The book is a gripping read. The sections on how Knight's company came to be called Nike and how the famous "swoosh" logo was chosen is worth the price of the book alone. After reading the book, it is clear why "Just do it" is a trademark of Nike.

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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