Conscious Investor® Fund
Annual Letter to Members: 2017 - 2018

Contents

Safety and performance

Safety: Protecting your capital: peace of mind

Warren Buffett says the first two rules of investing are

Rule 1: Don't lose money

Rule 2: See Rule 1

We agree, and we hope you do to. Bottom line performance is important: even more important is the protection of your capital. The Fund will never take any action that might improve the bottom line if it would risk your capital.

Stock markets fluctuate so it is inevitable that there will be periods when there are negative returns. The Capital Allocation Team consisting of Howard Coleman, Stephen Harrison , Mark Moreland and myself chooses companies that are least likely to be affected by such negative periods. It then carries out tests to verify this.

Looking at rolling three-month periods starting each month, over the past 5 years the S&P/ASX 200 Accumulation Index lost money 19 times. The good news is for 84% of those times, Fund members lost less money or actually made money. We feel pleased with this result.

Specifically, the average loss of the index for the 19 losing three-month periods was -3.39%. In contrast, over these same periods, the Fund lost an average of -0.25%.

Conclusion: The Conscious Investor Fund successfully protected Members' capital during losing markets.

Performance: Growing your wealth

As you know, the focus of the Fund is on great companies that have had strong and consistent growth in their earnings per share with all the signs that this growth will continue in the future. This is precisely what has led to the exceptional returns of Berkshire Hathaway over the decades. Warren Buffet regularly makes this clear recently telling his investors in Berkshire Hathaway: "*At Berkshire what counts most are increases in our normalized per-share earning power. That metric is what Charlie Munger, my long-time partner, and I focus on – and we hope that you do, too.*"

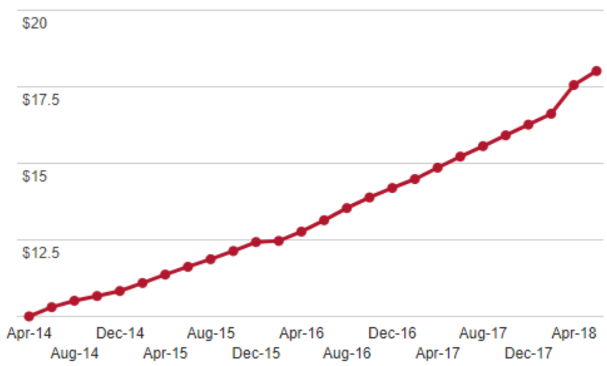
Ditto from us … "And we hope you do, too."

Sometimes growth in earnings will outstrip the share prices of the companies. In this case the performance may not look so appealing. Other times, the share prices will outstrip, on average, the growth of the earnings.

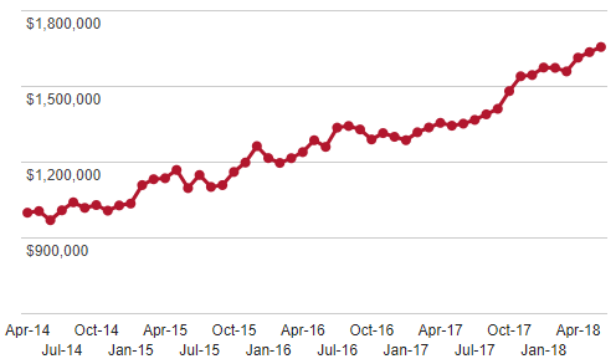
This is just the way of things. And when either one happens, it is not particularly a time to cheer or to commiserate.

It so happens, though, that the period 2017-2018 was one of the years when the share prices of the companies in the Fund did particularly well compared to their earnings and all the standard indices. After fees (data fees and success fees), an investment in the Conscious Investor Fund and held for the year would have grown by 22.08% compared to 13.03% for the S&P/ASX200 accumulation index.

The following two charts give more detail. The adjacent chart shows how much the average earnings per share for companies in the Fund have grown since April 2014, a general indicator of future growth of capital gains and dividends. We assume a starting figure of $10 in April 2014. The average growth per year is around 15%.



The next chart shows the growth of the true dollar value of an actual investment in the Fund since April 2014 after any success fees and assuming distributions (if any) are reinvested. Over this time, an investment of $1.0m grew to $1,656,314.61. This a total growth of 65.63%, an average of 13.08% per year. In contrast, an investment in the S&P/ASX 200 accumulation index would have grown to $1,371,761.21, an average of 8.00% per year, over the same period.



This table summarises the results.

	Growth of $1,000,000	Total Return	Average Annual Return
Conscious Investor Fund	$1,656,315	65.63%	13.08%
Accumulation Index	$1,371,761	37.18%	8.00%
Extra Performance	$284,553	28.46%	5.07%

Contributors to Performance

Even though performance of individual companies in the Fund is important, their proper importance is only apparent when we know how much of each company is held by the Fund. For this reason, we like to consider the absolute contribution as measured by the dollar amount contributed to the portfolio over the year.

On this basis, the largest contributor to the Fund's performance over the financial year 2017-2018 in Australian dollars was Bank of Internet (BOFI) which contributed +2.3% to performance. This means that the addition of BOFI to the Portfolio lifted the absolute performance by +2.3%. Thank you, Greg Garrabrants, President and CEO, for growing earnings per share by over 30% per year for the past five years.

The next four largest contributors were Blackmores Limited, Baidu, Mastercard and Flight Centre adding +1.2%, +1.1%, +1.1% and + 1.0% respectively.

One of the detractors was Technology One detracting by 0.9%. This is one of those cases that the market decided that they would pay less for it even though earnings per share continue to grow.

Last year, Sirtex was the main detractor from the overall performance. Since then two separate companies have made takeover offers for the bio-medical company with the result that it was a contributor for the year. A salutary lesson that when a company has valuable, proven products, eventually either the market will recognise this value, or an outside acquisitive company will.

The elephant was there all the time

Over the years, Warren Buffett has often said that he needed to hold a large amount of cash in Berkshire Hathaway, at least $20 billion, to be ready to catch large fast-moving elephants. Unfortunately, over recent years the cash has been increasing faster than he could find the opportunities he wanted so now Buffett has over $100 billion in cash at his disposal. In a recent letter to shareholders he wrote:

> *We continue, however, to need "elephants" in order for us to use Berkshire's flood of incoming cash. Charlie and I must therefore ignore the pursuit of mice and focus our acquisition efforts on much bigger game.*

There are two standard measures of Berkshire shares: book value and share price. In simple terms, book value tells us how much money was put into a business and share price tells us how much the market is willing to pay for it. Since Buffett took over Berkshire Hathaway, its book value has grown on average 19.1% per year compared to 20.9% for its share price. This may not seem like a big difference, but when it applies year after year over 53 years the results are extraordinary. The power of compounding caused book value to grow by 1,088,029%: with just a few percent more in per-year growth, the share price grew by 2,404,748%, more than twice as much.

The main reason why investors are willing to pay increasingly higher prices for Berkshire Hathaway book value is because acquisitions of whole companies made by Berkshire are still carried at their purchase price or 'book value'. In contrast, in many cases their 'true' value has increased by huge multiples.

A simple example is See's Candies. Bought for $25 million in 1972, it now has sales of around $500 million every year. Another example is GEICO Insurance first fully acquired by Berkshire in 1995. Since then it has gone to record levels with over 16 million customers.

On 12 December 2012, Berkshire Hathaway announced that it may purchase additional shares in the market or through direct offerings at no more than 120% of book value. In other words, 120% of book value was a type of floor on the share price. Buffett wrote:

> *Today, the large – and growing – unrecorded gains at our "winners" make it clear that Berkshire's intrinsic value far exceeds its book value. That's why we would be delighted to repurchase our shares should they sell as low as 120% of book value. At that level, purchases would instantly and meaningfully increase per-share intrinsic value for Berkshire's continuing shareholders.*

At the time Berkshire Hathaway purchased 9,200 of its Class A shares at $131,000 per share from the estate of a long-time shareholder.

Since then, the lowest ratio of the price to book value was around 1.40, so there were no further opportunities for Berkshire to repurchase its shares under the "120%" rule. (Currently it is 144%.)

But there has been change. Last month the Board of Directors of Berkshire authorized that share repurchases can be made at any time that both Warren Buffett and Charlie Munger, a Berkshire Vice Chairman, believe that the repurchase price is below Berkshire's intrinsic value, conservatively determined.

One caveat that will continue is that the total cash holdings will not drop below $20 billion.

No one knows quite what the practical outcome will be: but it does open up the likelihood of repurchases above the old "120%" rule. Perhaps Buffett sees that his own shares were really elephants all along waiting to be captured.

One thing we all should be pleased about since Berkshire Hathaway is one of our top-ten holdings: Warren Buffett and his small hand-picked team in head office are constantly looking for ways to use his pile of cash as effectively as possible. This is something we applaud. Feel free to join in.

We will also watch closely for opportunities to add to our holdings Berkshire Hathaway shares as more money comes into the Fund.

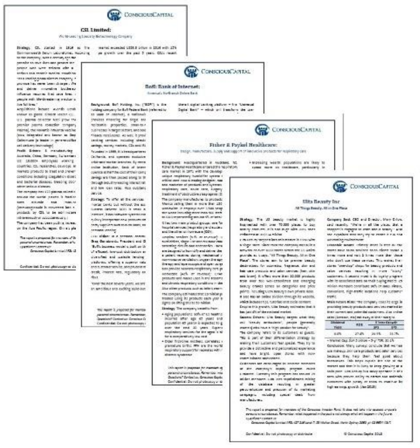
Why we do one-page summaries

One of the most successful investors of all time was Peter Lynch while managing the Magellan Fund at Fidelity Investments between 1977 and 1990. During his tenure, assets under management increased from $18 million to $14 billion. In his famous book *One Up On Wall Street* he wrote:

> Before buying a stock I like to be able to give a two-minute monologue that covers the reasons I'm interested in it, what has to happen for the company to succeed, and the pitfalls that stand in its path. The two-minute monologue can be muttered under your breath or repeated out loud to colleagues who happen to be standing within earshot. Once you're able to tell the story of a stock to your family, your friends, or the dog and so that even a child could understand it, then you have a proper grasp of the situation.

This prompted us to do something similar for companies we hold (or are considering), but in written form rather than orally.

Even though we prepare detailed analyses of companies for the Fund, these are for internal purposes. Our final goal was to end up with something similar to what Lynch was talking about, but in a written form. We arrived at the idea of a one-page summary.

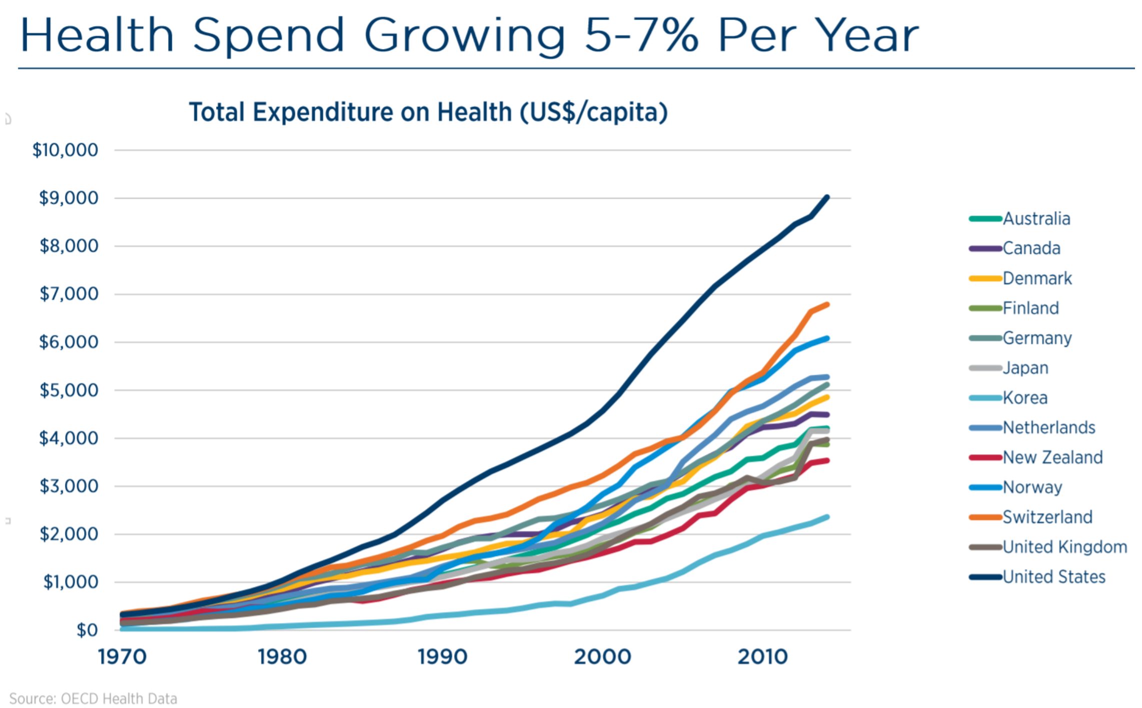


These summaries force us to focus on the key attributes of the company: how it makes money, who its main customers are, its key risks and economic moats, followed by a brief financial summary.

We hope you find them useful. We certainly find that preparing them sharpens our understanding of why we want the particular companies in the Fund.

Healthcare sector

In developed and developing countries around the world, healthcare expenditure is at record levels, and rising. According to recent data from the OECD it is growing by around 5-7% per year. In the US it is currently around US$10,200 per year per person; Australia is around US$4,500 per year per person. (See the following chart.)



This is why Warren Buffett recently stated: "The ballooning costs of healthcare act as a hungry tapeworm on the American economy." In a press release at the start of the year, Jeff Bezos (who runs Amazon.com), Warren Buffett (who runs Berkshire Hathaway) and Jamie Dimon (who runs JPMorgan Chase) announced a non-profit healthcare venture targeted at cutting spiralling costs for their employees. These three companies have a collective 1 million-plus workers and a combined market capitalization of over $1.5 trillion. The implication was that if they are successful within their own companies, there is a possibility of expanding it to other companies.

The project is scant on details and will have little effect on healthcare costs for quite some time. But it is a start.

In the meantime, we are comfortable with the various holdings in the Conscious Investor Fund related to the healthcare industry. Apart from normal healthcare demands, the services of these companies are impacted by:

- Aging populations: 60% of US healthcare cost is incurred after age 65 years and the US population 65 years+ is expected to grow ~80% over the next 20 years
- Increasing wealth: populations are likely to spend more on healthcare, particularly in developing countries
- Smoking rates: increasing in developing countries. Collectively, smoking is responsible for 5-6% of all ill health globally according to the Global Burden of Disease study and its share is rising over time
- Increasing obesity levels: putting more demands on healthcare systems.

We have some first-rate healthcare companies in the Fund that have contributed nicely to the performance over the past years. One that stands out is Fisher and Paykel Healthcare. A strange name but a brilliant performer with per-share earnings growing by 23% annually over the past five years.

Fisher and Paykel

The key expertise of Fisher and Paykel Healthcare (FPH) is to heat and humidify air within precise limits. Sounds simple? It isn't. When people are on respirators for extended periods of time, the ability to control the temperature and the humidity of the air they breathe is critical for their well-being and ability to recover. This is where Fisher and Paykel enter. The company has over 2000 patents in the areas of invasive and non-invasive ventilation, nasal high flow therapy and surgical humidification, as well as obstructive sleep apnea.

Today, the company employs over 4,000 people who are based in 36 countries and serve over 120 countries around the world. It is estimated that 13 million patients are treated using its products each year. Revenue is primarily from hospitals (58%), the remainder from homecare. It is worth noting that over the 2017 financial year, revenue growth from consumables grew by 22%.

The company describes its culture as "Care by design" which it says is a simple way of expressing the care and intentionality they put into everything they do.

There are also healthcare holdings in Blackmores, CSL, NIB Holdings, Cochlear and Resmed, together making up about 23% of the total portfolio.

Keeping costs and your taxes down

The Conscious Investor Fund focusses on companies that are going to be increasingly profitable over the years. This benefits you, our members, in many ways. For a start, and most importantly, it ensures we are very fussy about the companies in the Fund portfolio ensuring they have all the hallmarks of long-term Wealth Winners. (See the section in the Information Memorandum *How We Invest* for more details.) We like to follow Warren Buffett when he declared: *Stick with big, "easy" decisions and eschew activity.*

Second, it keeps trading costs to a minimum (which, indirectly, are paid by you, our members) and so helps the net performance of the Fund. Third, something that is not realised by most investors, it keeps your taxes associated with the Fund as low as possible. (Even zero when there is no distribution.)

This is because capital gains from transactions are required to form part of distributions made by funds. Such distributions may look attractive, but frequently they have unwanted tax consequences for individual investors that are not reported in the net performance of the fund.

We don't buy and sell simply to generate distributions which you may have to pay tax on.

In addition, despite appearances, distributions do not add value since the amount of the distribution is subtracted from the unit price. For instance, if the Unit Price is $1.50 and there is a distribution of $0.05, the unit price immediately drops to $1.45. Also, the 5-cent distribution becomes part of your tax return whether you have it paid into your account or it is reinvested in more units.

Another reason why the Conscious Investor Fund will generally accumulate lower funds for distributions is that the type of companies it focusses on tend to have lower dividend yields because they are chosen for the ability to grow year after year. In many cases they don't even pay any dividends. This applies to the majority of the US investments, particularly Berkshire Hathaway.

Financial Year 2017-2018

Even though the value of the Fund went up over 2017-2018 (the unit price grew by 22.08%), there was no net income for distribution. The reasons for this, broadly speaking, are that we did minimal trading (so no capital gains), most of our investments are either low or zero dividend yield (so minimal dividends), and last year we had a reasonable success fee (because our net performance for the year was over 22%).

The result is that there was no distribution for this year.

We know that for a small number of you having an actual distribution paid out in cash is important. I hope the above discussion makes you feel a little easier about this. The focus of the Conscious Investor Fund is long-term wealth creation. We can say, though, if you need more income from the Fund for any reason, we have made it as easy as possible with a single one-page withdrawal form. But we hope you prefer to add, rather than withdraw funds.

Companies with a noble purpose

The most successful companies usually have a clear statement of mission or purpose that goes beyond the everyday products they sell or services they provide.

Consider Cochlear. It states its mission as:

> *We help people hear and be heard. We empower people to connect with others and live a full life.*

Just to read this statement is uplifting. There is nothing here about designing, marketing and implementing cochlear hearing implants; nothing about marketing and sales. In a sense, these activities are an outcome or consequence of the company's mission statement, rather than the other way around. With such a statement the company is now on the alert for any products or services, or changes in the way they do things, that will help people "hear or be heard".

When companies introduce a statement such as Cochlear's, it acts as a guide for everyone right throughout different levels of the company. It acts as a touchstone or benchmark for all activities and decisions.

Another company in the Fund with a clear purpose or mission is Flight Centre stating it as:

To open up the world for those who want to see.

Again, nothing directly about the products sold by the company. That comes in the follow-up vision statement:

To be the world's most exciting travel company, delivering an amazing experience to our people, customers and partners.

When discussing these statements and how they arrived at them, the co-founder and CEO of Flight Centre Graham Turner wrote: "We aligned the global team around a common purpose — We care about delivering amazing travel experiences. We worked with our country leaders to implement the strategy in each market [and] and translated it into strategy, process improvement, messaging and behavior."

The result according to the company: improved customer ratings, greater organizational alignment, and a more proactive customer-oriented sales approach. The following year revenue increased by 6.8 % and Flight Centre showed a 31.1% increase in (PBT) Profit Before Taxes.

Vision, mission statement, purpose, tagline, goal and so on. Different companies use different terms to describe this idea of a clear statement that goes beyond the immediate daily activities of the company. Not many actually use the term noble purpose. Perhaps it sounds too grandiose. The important thing, though, is to research whether a company has such a unifying statement or vison, irrespective of what they call it.

What I like about the term noble purpose (or simply NP) is that it incorporates all the other terms, vision, mission statement and so on, and lifts them to a broader, more fulfilling level. It is very enjoyable when considering a company for our Portfolio to see if it has a noble purpose even if it may use a different term.

Of course, having an NP is not a magic bullet: FLT COO Melanie Waters-Ryan said: "It doesn't solve other problems, it won't solve technical issues, it won't cover up bad practices." Noble purpose shines a light on areas of your business that may be out of alignment with your aspirations. "If you fix those, Noble Purpose adds to it brilliantly."[1]

The result is that Flight Centre has some of the highest employee satisfaction scores of any company.

Waters-Ryan continues: "We as a brand need to give people something to be proud of. We need to show them where they add value. We need to help them feel even prouder of what they have." The NP helped to do this.

The Washington Post and the seven principles

The history of Washington Post provides a compelling story of the importance of having a guiding purpose and sticking with it.

It is now one of the world's great newspapers but its early years of the post were a struggle. When former Chairman of the Federal Reserve's board of governors, Eugene Meyer, bought it in a bankruptcy auction in 1933 it was far from certain that it would survive.

But it doggedly held on outlasting many of its Washington rivals while expanding its international coverage and its reputation. In 1946, Meyer was succeeded as publisher by his son-in-law, Philip Graham. After his death in 1963, control of the paper passed to his wife, Katharine Graham. (She

[1] *Leading with Noble Purpose: How to Create a Tribe of True Believers* by Lisa Earle McLeod

describes her anxiety and lack of confidence in her autobiography.[2] You also see something of this in the film *The Post*.)

While Phil Graham was in charge he introduced a comprehensive mission statement referred to as “the Principles”. They include:

“The first mission of a newspaper is to tell the truth as nearly as the truth may be ascertained.”

“In the pursuit of truth, the newspaper shall be prepared to make sacrifices of its material fortunes, if such course be necessary for the public good.”

Today these principles are displayed in brass linotype letters in an entrance to the newsroom.

There were two well-known separate occasions when the paper may not have survived without adherence to these principles. The occasions hinged on whether or not the Post should publish the Pentagon papers in 1971 or the details of the Watergate break-in in1972. In both cases the majority of board and key investors were against publication. Also the company’s lawyers. But Katherine Graham overruled them in both cases ordering the stories be published risking survival of the paper. She quoted the “principles” articulated by her late husband as giving her the courage and the guidance to make these tough decisions.

Postscript: The Post is now owned by Jeff Bezos, the founder of Amazon.

What does having an NP mean for companies in the Fund?

Increasing research shows that companies with an NP embedded in their structure outperform their competitors.[3] The Information Memorandum and all the literature produced by the Fund describes the comprehensive process of evaluating companies before we would consider investing in them.

The exciting thing about noble purposes is that this adds another evaluation approach that is more than another perspective. It is really an overarching viewpoint via which the other perspectives such as decisions, remuneration, acquisitions, appointments and goals can be evaluated.

This does not mean that all the companies in the Fund have clear NPs. But a surprising number do. We believe it is important when evaluating companies to scan through their material to see if (1) they have a clearly stated NP, and (2) whether they use it to support the decisions and culture within the company. We also enjoy the search.

Some companies even have their NP as part of their logo. Three examples are Technology One, iiNet, a subsidiary of TPG Telecom, and Ramsay Health Care. The logo for iiNet even has two stylised people who, by inference, are “connecting better” because of iiNet.

technologyone
Transforming business, making life simple

iinet
connect better

Ramsay Health Care
People caring for people

[2] *Personal History* by Katherine Graham

[3] Total Societal Impact: A New Lens for Strategy by Douglas Beal and co-authors (Boston Consulting Group, October 2017)

Note that although an NP has direct impact on the products and services of the company, it often has application to the broader goals and qualities that make life more enjoyable and fulfilling: empowering people, opening up the world, making life simple, more meaningful lives, and so on.

Noble Purpose for the Conscious Investor Fund

Following Warren Buffett, the focus of the investments in the Fund is growth. Growth of per-share earnings accompanied where appropriate with per-share sales and market share. But growth also has a broader meaning of progress and development. So “growth” is a natural fit as part of a noble purpose or mission statement for the Fund.

What else? I was always impressed by an early statement by Warren Buffett that he wrote his letters to the members of his early partnerships and later the annual reports of Berkshire Hathaway as if his sisters were reading them. He wanted to write them in such a way that they would understand them.

Something similar has been a guide for everything we write for you, our Fund members, starting with the Information Memorandum and continuing through the bimonthly EPS reports, the one-page company summaries, and the 6-monthly letters. When we write them, the Capital Allocation Team and I wanted to put ourselves in the shoes of an investor and provide the sort of information that we would like to know.

We wanted them to be clear. We wanted them to have a reasonable amount of quantitative information. We also wanted to explain, as we did at the start of this Letter, how the Fund has protected against down markets.

But always at the back of our minds was whether they would help to give peace of mind. Peace of mind became the benchmark for all the reports.

This leads to the second part of the noble purpose of the Fund: peace of mind.

So we arrive at:

> *Growth with peace of mind.*

This provides a test for everything that we do for the two sides of the Fund: choosing investments and providing information for you, our members. These two sides also support each other. The more growth in the individual investments, the greater your peace of mind because of the performance. And the better we can explain what we are doing, the greater your peace of mind and the more confidence you will have in our search for growth.

What Warren Buffett did not say

A recent article by David Moon has a quote I thought you would enjoy. Hordes of analysts parse everything written or spoken by Warren Buffett looking for ideas for their next investments. Or next article. David turned this around and pointed out what Buffett did not say. Here is the quote referring to the recent Buffett letter to shareholders (quoted with permission):

> *The letter doesn’t contain the phrases “Dow Jones Industrial Average,” “Bitcoin” or “cryptocurrency.” Buffett never discussed moving averages or if the stock market is nearing either a resistance or support level. He didn’t mention beta, alpha, portable alpha, standard deviation, variance, tactical asset allocation or Sharpe ratios. The closest he came to*

mentioning GDP was noting that, regardless of the problems of the minute, the U.S. economy has grown since 1776, and he doesn't expect that to change.[4]

It helps keep investing simple when all these concepts can be discarded.

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 in markets around the world 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 five 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.
- Does the company have a clear mission statement or noble purpose? Is there evidence that the company uses it to guide its decisions, appointments, acquisitions and remuneration policy?
- Is management honest, open and rational? As part of examining the business, evaluation is made of the board and senior management: are there any signs that they are not 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.

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: cifund@consciouscapital.com.au

Conscious Capital Limited AFSL 427 216 9/2 Kochia Lane, Lindfield NSW 2070, ph (02) 9416-1941.

[4] *What Warren Buffett didn't say* by David Moon (Knox News, 1 March 2018)