Conscious Investor® Fund
Annual Letter to Members: 2020 - 2021

Dear Fellow Members of our Conscious Investor Fund:

Welcome to our annual 2020-2021 letter. We hope you enjoy it and find it useful. Before getting started, we hope you and your family are well and keeping safe in these challenging times.

The last 12 months were extremely volatile. But I am happy to report that your Fund performed extremely well with a performance of 29.94% after expenses and fees, assuming distributions are reinvested. This means that an investment of $1 million on 1 July 2020 would now be worth $1.299 million on 30 June 2021. More relevant, an investment of $1 million on 1 July 2016 would be worth $2.035 million on 30 June this year, more than doubling over 5 years.

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The Power of Earnings

Looking at the chart of the share price of a company shows a tortuous line of hills and valleys. What drives this path? There are two components, earnings, particularly earnings per share (EPS), and the P/E ratio (PER). They are joined by the formula:

$$\text{Price} = \text{EPS} \times \text{PER}.$$

This shows for the price of a share to grow we need either the EPS to grow or the PER to grow (or both). I think of these as the objective and subjective components of share price. EPS is objective since it is calculated from the financial statements of the company and PER is subjective since it is an outcome of the beliefs of the market participants.

Starting with EPS, the members of the Capital Allocation Team focus their attention on finding companies that have had strong and consistent growth in EPS with clear signs this will continue in the future. As Warren Buffett said, he wants companies that are easily understandable “whose earnings are virtually certain to be materially higher five, ten and twenty years from now”. This is why, when we provide our list of the ten largest holdings every two months, we include the growth of EPS over 12 months and five years.

Shifting to the PER, Conscious Investor allows us to see the ranges of the ratio each year for up to ten years. This enables us to determine whether the current PER is low, medium or high compared to its historical levels. We can also compare the current PER with the PERs of comparable companies and of the market as a whole. Our aim is to make investments when the PER is at a low or medium level in companies that have had strong earnings growth plus, as just stated, clear signs this will continue.

Analysis of Technology One

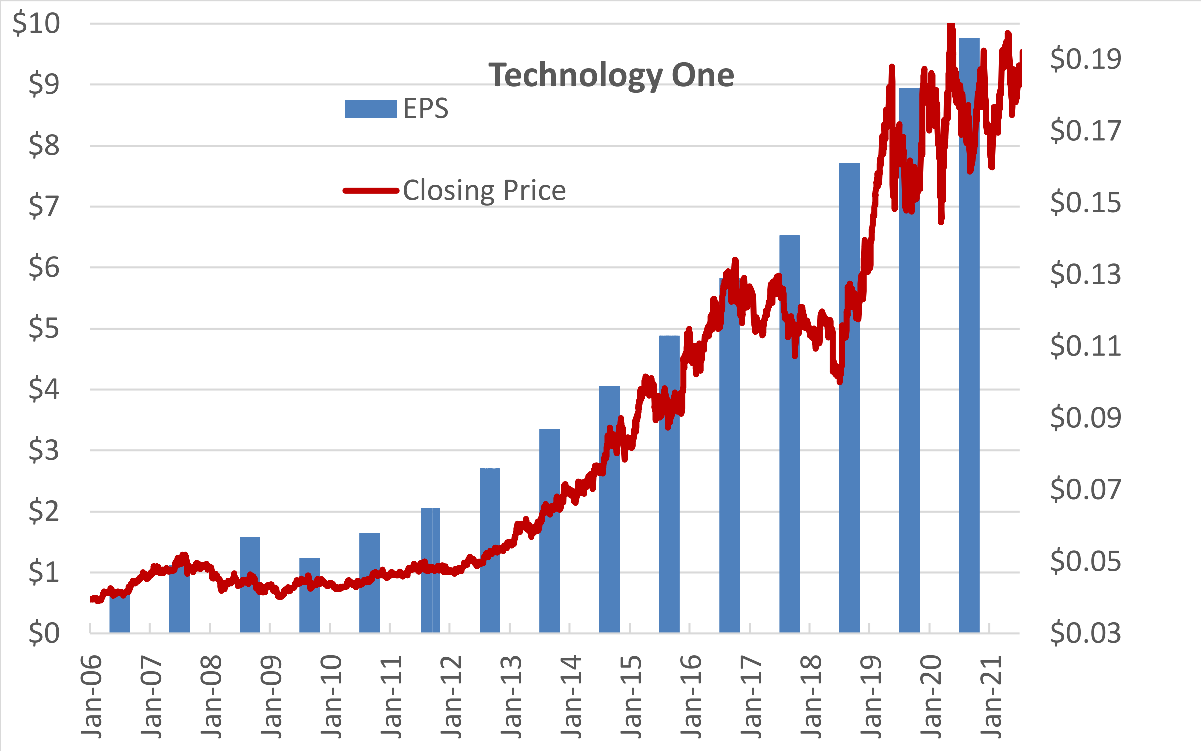
Let’s have a look at how this relationship is put into practice with Technology One (symbol: TNE), one of our earliest investments. On its website, TNE states its noble purpose is to “build and deliver truly great products and services that transform business and make life simple for its customers”.

Its approach via its SaaS model “transforms the way organisations interact with their customers and communities with access from any device, anywhere, at any time”. The company continues: “Our solutions run on one global code line, providing massive economies of scale to our customers”.

The first parcel of TNE was bought in June 2015 for $3.57 per share. Since then, working on a weekly basis, 50 further parcels have been bought, the most recent being in June 2021 for $8.84 per share. Parcel sizes ranged from 12 (because the price jumped before the full order could be completed) to 50,000. The current share price is $9.46 resulting in an overall total shareholder return (which includes dividends) of 23.10% per year. The most recent price was almost 2.5 times higher than the first purchase. Yet, because the earnings have grown so much over that time, the most recent purchase price is just as likely to provide excellent future performance as the original one. Already just two months later the price has grown by 7.13%.

Our stubborn goal is to look for opportunities where TNE is “cheaper” in terms of its PER than it was back in 2015.

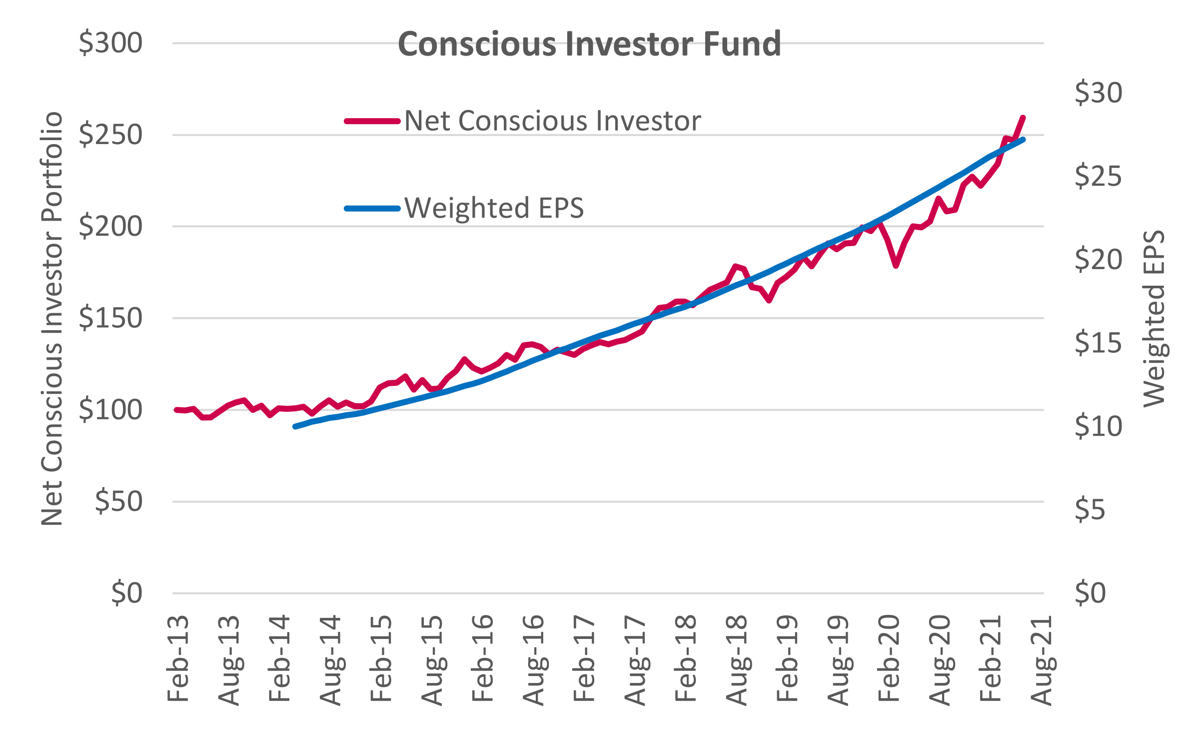
The next chart gives a visual display of how, for quality companies such as Technology One, the share price and the EPS track each other. Sometimes the price runs ahead of the EPS, sometimes it lags behind, but over time they match each other.



Analysis of the Overall Portfolio

We can do analyses such as the one we just did for each company in the Fund. The challenge, though, is to compare EPS and the PER across the overall portfolio. This becomes complicated because we are dealing with differing amounts for over twenty companies that make up the final portfolio and because the levels of the EPS are quite different ranging from under a dollar for companies such as Technology One to over sixty thousand US dollars for Berkshire Hathaway Class A shares.

We overcome this complexity by using a weighted average of the EPS of each company starting with a normalised amount of ten dollars. The outcome is shown in the next chart which compares the weighted average of EPS with the growth of the Conscious Investor Fund assuming a starting point of $100. Just as for Technology one, sometimes the Fund runs ahead of the weighted EPS, sometimes it lags behind. But over time, they match each other.



Contribution of Companies in the Fund

How much a company contributes to the performance of the Fund depends on the performance of the shares in the company held by the Fund and the number of shares.

Below we list in alphabetic order the contribution of the ten largest holdings in the Fund, plus the contribution of the remaining holdings including cash, since inception. Overall, the Fund has bought a net amount of $58,989,680 of shares. These shares are now worth $109,025,625 including dividends and foreign exchange gains. This means that the Fund has added over $50 million in value for you, its Members.

Shares	Market	Name	Cost[1] (AUD)	Market (AUD)	Gain
2,110	NASDAQ	Alphabet Inc Class A	$3,082,691	$6,871,402	$3,788,710
94,100	NYSE	Axos Financial Inc.	$4,183,523	$5,821,951	$1,638,428
16,665[2]	NYSE	Berkshire Hathaway[2]	$3,171,616	$6,186,210	$3,014,594
7,750	NASDAQ	Costco Wholesale	$1,916,613	$4,089,681	$2,173,068
19,350	ASX	CSL Limited	$3,412,523	$5,518,427	$2,105,903
149,000	ASX	Fisher & Paykel H.	$1,779,953	$4,309,080	$2,529,127
190,000	ASX	Mineral Resources.	$1,796,935	$10,208,700	$8,411,765
166,900	ASX	Resmed Inc[3]	$3,689,335	$5,475,911	$1,786,576
560,000	ASX	Technology One	$2,842,437	$5,213,600	$2,371,163
17,500	NASDAQ	Tractor Supply	$2,567,122	$4,342,558	$1,775,436
	Remaining Holdings		$30,546,933	$50,988,106	$20,441,173
Total Equity Investment Carried at Market[3]			$58,989,680	$109,025,625	$50,035,945

Notes:

1. These are the actual total purchase prices
2. Each Class A shares is converted to 1,500 Class B shares.
3. This is the combined holding in Australia and the US converted to Australian shares.

Looking for Quality Management

Number crunching large amounts of data is a core part of how we generate healthy returns for our members in the Fund. We do our number crunching largely through Conscious Investor. But there is another crucial part: finding companies where we are confident that the board and management are of the highest level of competence and trustworthiness.

As usual in these situations, Warren Buffett has already thought carefully and deeply about this providing us with guidelines for us to employ.

In his 1986 letter to investors, he wrote

> *Charlie Munger, our Vice Chairman, and I really have only two jobs. The first is to attract and keep outstanding managers to run our various operations…. The second job Charlie and I must handle is the allocation of capital*.

Buffett, of course, is talking about the aspect of Berkshire Hathaway where it is purchasing entire businesses. Transferring this idea to the Capital Allocation Team, we also have two jobs: recognising quality management running quality companies, and allocating capital appropriately when we find such companies.

In his letter *Assessing CEOs at AGMs*[1], Howard Coleman lists eight common characteristics of successful CEOs identified by Teaminvest members. Although the article refers to AGMs, they still apply to what we look for in all presentations by or in meetings with CEOs. They also apply to reports and letters written by the CEO. The points in Howard's letter:

1. They spoke with great passion for their business.
2. Their answers explained why their business made profits, not how they operate.
3. They had a social conscience, aiming to do good for people and perhaps the world.
4. They spoke highly about their staff and the high quality of people they recruited.
5. They admitted to weaknesses and to recruiting experts to cover those weaknesses.
6. They didn't blame outside circumstances, instead openly admitted to making mistakes.
7. They didn't ask for taxpayer funds, government help, or regulator protection.
8. They were enthusiastic about answering interested shareholders like us (many said 'partners').

When we find companies with management meeting these criteria, we can be confident that no matter what the business world throws at them, they will come out with increasing profits. It is a pleasure to sit back and watch them turn what at first looks like a difficult situation into a positive outcome. As expected, we are enjoying many examples of our companies delivering excellent outcomes notwithstanding the current pandemic and lockdowns. Just like Buffett, we get out of the way and derive benefit from choosing to invest with skilled managements.

The final job of the Capital Allocation Team depends on filtering the companies through Conscious Investor looking for those businesses with the highest likely total shareholder return over at least the next five years.

[1] *Finding Wealth Winners® the Teaminvest Way* by Howard Coleman and John Price (pages 287-291).

Human Ingenuity in Energy

We're always on the lookout for companies showing amazing ingenuity. But only once their management has proven that they are able to turn this ingenuity into a commercial success and their track record allows them to pass the stringent filters we employ in Conscious Investor. So we watch companies exhibiting extraordinary ingenuity with interest, but only commit your funds once we are confident that their ingenuity will generate acceptable financial returns. Here are some of the innovative ideas in the area of energy we look at in the hope of finding the occasional diamond in which we can confidently invest.

We live in an age of energy. From the tiniest machines a thousand times smaller than a human hair powered by UV-light to giant earth-moving and boring machines weighing thousands of tonnes. They are all driven by energy.

One of the biggest problems is the storage and recycling of energy needed to power these machines. Two recent developments demonstrate human ingenuity in these areas and may one day lead to a commercial success.

Cost-Effective, Multi-Day Energy Storage Systems

As just stated, one of the major problems of energy is storage. Lithium batteries are the basic building blocks used to store electrical energy. But they have a limited time over which they can perform their storage function. This is the space in which Form Energy has developed a whole new approach.

According to its website, to run a power grid reliably and affordably, we need new cost-effective technologies capable of storing electricity for multiple days. To do this, the company has reinvented and optimized the iron-air battery for the electric grid. The website writes: "The active components of our iron-air battery system are some of the safest, cheapest, and most abundant materials on the planet — low-cost iron, water, and air. Iron-air batteries are the best solution to balance the multi-day variability of renewable energy due to their extremely low cost, safety, durability, and global scalability."

The first commercial product using its iron-air technology is optimized to store electricity for 100 hours at system costs competitive with legacy power plants. Its goal is to make renewable energy available when and where it's needed, even during multiple days of extreme weather, grid outages, or periods of low renewable generation.

Urban Mining Metals for Batteries

Jeffrey Brian ("JB") Straubel is often considered the brains behind Tesla: over lunch in 2003 he convinced Elon Musk that electric vehicles represented the future of transport. He then became chief technology officer for 15 years designing Tesla's first batteries. (He was their fifth employee.)

When he left Tesla his goal was to solve the environmental problem of the mining, manufacturing and disposal of batteries used in electric vehicles. He started a plant in Carson City, Nevada.

Every day, two to three heavy-duty trucks drop off about 60 tonnes of old smartphones, power tools and scooter batteries at his plant. The team of 130 employees separates out the metals — including nickel, cobalt and lithium — pulverises them and treats them with chemicals so they can re-enter the supply chain as the building blocks for new lithium-ion batteries.

The process of breaking down these batteries and repurposing them is known as "urban mining".

Straubel hopes that within 10 years recycling will bring the price of raw materials for lithium-ion batteries down to about half of what it costs to mine virgin material.

Stop-Press: Berkshire Hathaway 2nd Quarter Report

One of the largest holdings in the Fund is Berkshire Hathaway. During the 2nd quarter in 2021 Berkshire Hathaway repurchased US$6.1 billion of its stock in A shares and B shares. The average price for the shares paid by the company was $276.21 expressed in B shares. Today the Price of B shares is $291.28.

"Many of our businesses generated significantly higher earnings over the first half of 2021 compared to 2020, which included significant adverse effects from the pandemic," Berkshire said in its quarterly filing. "Earnings of our manufacturing, service and retail businesses in 2021 benefited from higher customer demand in many of our businesses and exceeded earnings in 2019 as well."

Second quarter operating earnings were $6.7 billion, an increase of 21.3% year over year.

Warren Buffett Corner

According to Warren Buffett, all large organizations face the potential 'ABC' risks of decay: Arrogance, Bureaucracy, and Complacency. He added: "When these corporate cancers metastasize, even the strongest of companies can falter."

As examples, in a letter to Mark Suzman, the CEO of the Gates Foundation, Buffett highlighted General Motors, IBM, Sears Roebuck, and US Steel as examples of corporate titans that once appeared to have unassailable grips on their industries. He said: "The destructive behavior I deplored above eventually led each of them to fall to depths that their CEOs and directors had not long before thought impossible."

This is why the Capital Allocation Team continually monitors the Fund investments to ensure none are showing signs of any of these "ABC" risks. Should we detect any of these worrying signs, we'd rather invest your money elsewhere.

Conscious Investor® and the Teaminvest Methodology

The starting point is our investment software, Conscious Investor®. It filters and analyses companies listed in markets around the world in three steps: Filter, Research and Return. The filter stage zeros 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 identifies those companies for which these attributes are likely to continue. Finally, the return stage calculates the maximum price to pay to be confident about getting the required rate of return over the long term. Conscious Investor uses automatic margins-of-safety calculations to stress test the investment assumptions.

Once this is done, the Teaminvest Methodology focuses on the following five areas and the Capital Allocation Team scores these areas to increase the precision of the decision process.

1. How does the company make money? Is the business expected to grow? Are there clear signs it will have a growing customer base?
2. 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.
3. Risks need to be identified: All businesses face risks that could potentially weaken 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 occur.

4. Does the company have a clear mission statement or noble purpose? Is there strong evidence that the company uses these to guide its direction, decisions and remuneration policy?
5. 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? The Capital Allocation Team scores the remuneration structures for the CEO and senior management in terms of clarity, alignment and quantum.

The final steps involve calculating buy and sell prices. You can find more details in the Information Memorandum. It also describes our processes to identify Wealth Winners while making it extremely unlikely we would place any of your capital in potential Capital Killers.

We hope you enjoyed reading this Letter. We chose the topics to help you better understand our philosophy and what motivates us in choosing investments for your money. Please let us know if there are any other topics you would like us to include.

We aim to continue being outstanding stewards of your precious capital you have entrusted with us.

Wishing you the very best health and well-being.

Kind regards,

(John Price and the rest of the Capital Allocation Team: Howard Coleman, Stephen Harrison and Michael Stewart)

P.S. I thought you might enjoy this quote from Ash Barty after she won Wimbledon:

"I think I've just tried to live by my values that my parents instilled in me. I mean, it's more important to be a good person than it is to be a good tennis player. So, I think that is always my priority, is making sure I am a good human being. I am extremely lucky that I was able to have an opportunity to learn how to play the game of tennis. But I think being a good human being is absolutely my priority every single day."

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.