**To:** **Investor Partners of Castlereagh Equity Pty Ltd**

**From:** **Peter Phan**

**Date:** **28 April 2017**

**Re:** **Monthly Update**

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| | Castlereagh Equity | ASX All Ordinaries | Relative Performance | CE Net Asset Value |
|---|---|---|---|---|
| 1 November 2013 to 28 April 2017 | 51% | 9.7% | 41.3% | 133.3 cents* |
| 1 November 2013 to 31 January 2015 | 6.2% | 2.4% | 3.8% | 106.2 cents |
| 1 February 2015 to 29 January 2016 | 19.4% | -9.2% | 28.6% | 126.8 cents |
| 1 February 2016 to 31 January 2017 | 19.7% | 12.5% | 7.2% | 151.8 cents |
| 1 February 2016 to 28 April 2017 | -0.5% | 4.8% | -4.5% | 133.3 cents |

To aid in understanding the tables above:

1. CE commenced on 1 November 2013 with shares issued at $1 per share, backed by $1 of cash per share.
2. The first row of the table above provides a summary of CE's performance since its commencement on 1 November 2013 until the date of this memorandum. It also compares CE's performance with the benchmark All Ordinaries index over the same period.
3. The second row of the table provides a summary of CE's performance for its first reporting period (15 months period from 1 November 2013 to 31 January 2015).
4. The third row of the table provides a summary of CE's performance for its second reporting period (12 months period from 1 February 2015 to 29 January 2016).
5. The fourth row of the table provides a summary of CE's performance for its third reporting period (12 months period from 1 February 2016 to 31 January 2017).
6. The fifth row of the table provides a summary of CE's performance for its fourth and current reporting period (period commencing 1 February 2017 to the date of this memorandum).
7. *CE NAV is after payment of dividend and director fees in Feb 2017.

The XAO started at 5420 on 1 November 2013 and ended at 5947 on 28 April 2017. In percentage terms, the XAO gained 8.9% for the 42 months period since the start of the CE fund. CE's performance over the same 42 months period is 51%.

For the month of April 2017, the XAO gained 0.7%. The CE portfolio had a slight drop of 0.5% for the month.

The cash component of the CE fund is just below 25%. We head into the traditional tax loss selling seasons and possible further market volatility in the coming months with plenty of dry powder.

**The Correct Way**

In my previous memorandum, I mentioned a talk given by Li Lu at Peking University in 2015. For those unaware, Li Lu is a manager who has been entrusted money by Charlie Munger. Many of you will be no strangers to Charlie Munger, a person that I consider to be one of my most important mentor.

The link given on my blog to Li Lu's translated speech is no longer working. If any investor partners would like to have a copy of this speech, please contact me directly.

In light of Li Lu's speech, I would like to take this opportunity to go back to basics. To go back to the fundamental reasons of how and why CE funds are being invested. More specifically, why your money is being invested based purely on the principles of value investing.

According to Li Lu, there are only 4 main principles in value investing. My preamble to these principles is to urge you to understand that value investing is not about buying cheap. At its crux, the word "value" in value investing is to be correctly understood as being distinct from price. No one said it better than Buffett: "price is what you pay, value is what you get." I might also add that investors often mix up these two different concepts at great peril to their wealth.

The four principles are:

1. A stock or share is a fractional ownership of a company.
2. The stock market exists to provide price quotes, not as an arbiter of value.
3. Invest with a large margin of safety to allow for uncertainty.
4. Identify and stay within your circle of competence.

In this memorandum, I will deal with the first principle. The remaining three principles will be covered in future memorandums in their respective orders.

**Principle 1: Shares are fractional ownership of companies**

This is a core and fundamental concept. Unfortunately, not many market participants are willing to embrace this totally. Investing in shares is actually investing in a company. If the company runs a business, shareholders are part owners of that business. A business is in essence a method/process/system/algorithm whereby capital is employed to generate more capital. If the business is successful in generating more and more capital without requiring further capital from its owners, it becomes more valuable. As the business becomes more valuable, its business owners/shareholders will participate and benefit from this increase in value.

Compare this approach to the more common attitude of shares being bought in the expectation that someone will pay a higher price for it. The so-called greater fool theory. Which approach is more sustainable? Which is "correct"? The correct approach is to earn what we deserve.

Having the mindset of a business owner means that we are foremost concerned with the fundamental attributes of the businesses we own. As I have stated in previous memorandums, a cafe owner is not concerned with the price levels of similar cafes changing hands. The cafe owner is primarily concerned with the delivery of goods and services of the business to generate increasing custom, which will hopefully increase the profits able to be drawn by the owner from the business. This underpins the value of the business in the eyes of the owner. This is sustainable, precisely because the owner earns what is deserved. Compare this attitude to a business flipper, akin to the methods of some private equity operators. Which is “correct”?

If we have the mindset of a business owner, it is automatically obvious that the value of a business is independent from the price someone is willing to pay for it. If a cafe is generating $100,000 in net income every year and does not have any debts, the owner will not entertain an offer to purchase the business for $50,000. The discrepancy between price and value is just too large.

In the private market, it is virtually impossible to find transactions with a large divergence between price and value. This is not always the case in the share market, which brings us to the second principle concerning Mr Market’s quotations. We will cover this next important principle in future memorandums.

**Portfolio**

The following are brief summaries of some of our major holdings at present:

1. A small regional bank overseas;
2. A provider of IT products and services;
3. A manufacturer and distributor of products in the dental industry;
4. An online advertiser;
5. A small financial planning and funds administration business;
6. A domestic formworks and scaffolding company;
7. A travel solutions retailer;
8. A medical billing and solutions provider;
9. A premium serviced office operator;
10. A small medical device company;
11. A mobile content distributor and mobile banking solutions provider;
12. A medical diagnostic service company;
13. A cold-chain logistics company.

Attentive readers may wish to compare this list with the list set out in our April 2016 memorandum.

If any investor partner wishes to contact me to discuss this memorandum or any other matters related to CE, please do not hesitate to do so.

Thank you for your trust and confidence in us.

Regards
Peter Phan
Director, Castlereagh Equity Pty Ltd