Portfolio performance

The portfolio returned 7.86% over the twelve months to June 30 2016 after management fees, outperforming the All Ordinaries Accumulation Index and MSCI World Index by 5.85% and 7.23% respectively.

In the six months ending June 30, the Portfolio returned 0.86% in difficult conditions when the MSCI World Index fell 1.47%.

Market conditions

The US economy has generally improved since the fall in 2009. The household sector continues to be supported by a declining unemployment rate of 4.7% and a robust housing market. Surprisingly, wage inflation has not been a feature of this recovery. However, we expect wage inflation to rise as the economy approaches full employment.

The primary driver of US GDP is consumption, responsible for 68.6%. Government consumption and investment represents 17.6% and is expected to have a small positive contribution to GDP growth in 2016-17. With the US election scheduled for 8 November 2016, we do not expect any significant change to government spending.

Housing continues to be a bright spot with new home sales reflecting the underlying health of the sector. Housing affordability has been supported by solid employment data, low interest rates and an accommodative Fed. The Housing Affordability index remains considerably above its 2006 lows.

Political headwinds are rising in Europe as the solidarity of the EU is tested by Brexit. Has its equilibrium been permanently disrupted with the exit of Britain? What are the long run implications for Europe? We believe it is too early to tell, however the continued bias toward accommodative monetary policy is likely. Monthly asset purchases of €80 billion are intended to run until the end of March 2017 or beyond.

Macroeconomic projections for the Euro area foresee real GDP to increase 1.6% in 2016 and 1.7% in 2017 and 2018 supported by low oil prices and falling unemployment levels. Inflation continues to disappoint, and the ECB is ready to respond.

Portfolio Investments

The top three contributors to Portfolio performance in the year to June 30 were LinkedIn, Alphabet and Home Depot, while the bottom three were ING, Lloyds and CSX Corp.

LinkedIn was the target of an opportunistic raid by Microsoft (another portfolio holding), which agreed to acquire it for US$26.2 billion, a 50% premium to the share price. We acquired a position in LinkedIn following its share price decline to $105 (from $190) in February this year. While we are disappointed to lose a great business, we believe the acquisition will create meaningful revenue synergies for the acquirer as the LinkedIn business is integrated into Microsoft's productivity solutions segment. We increased our weighting in Microsoft by 1% following the acquisition announcement.

The deal provides Microsoft with the world's largest professional social network with the ability to power data tools for Microsoft Dynamics (which competes with Salesforce). We also believe Lynda, the training business opens a large new addressable market opportunity for Microsoft.

The prospect of prolonged negative rates in Europe saw us exit our positions in Lloyds and ING. Although both banks operate with leading positions and have strong capital ratios, we are concerned about the prospect and duration of negative rates in Europe. We exited both prior to the BREXIT vote.

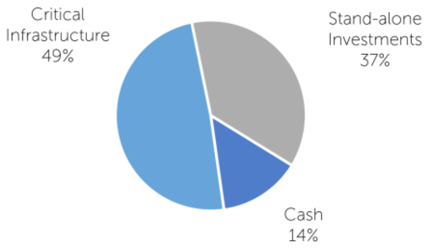
We also exited our investment in CSX as the prospect of rail consolidation in the United States now seems remote. Part of our investment in CSX has been redeployed to our other rail holding, Union Pacific (UNP). UNP is exposed to the same underlying structural story as CSX. However, it has a stronger economic franchise and larger exposure to Mexico.

Mexico is set to supplant China as the US's largest trading partner in the medium term and Mexican exports to the US have more than doubled since 2009. A 40-foot container from China to the US takes 4 weeks and costs $4,300. The same container from Mexico costs $1,800 and takes just one week.

Since 2010, Chinese manufacturing wages have passed Mexican and have quintupled since 2004. Mexican wages have risen 50% over this time but when adjusted for productivity, labour costs are now 13% lower than in China. This bodes well for Union Pacific as the leading provider of transportation services to and from Mexico serving all six major gateways.

Portfolio segments

We have segmented our investments to make it easier for investors to understand the underlying drivers of portfolio performance. We evaluate our investments along a number of dimensions which span critical infrastructure, unique stand-alone investments and cash.



We define critical infrastructure as assets, systems, networks or platforms that are necessary to facilitate commerce in a particular industry. We own critical infrastructure from a wide array of industries including rail networks, payment networks, IT platforms, and midstream oil and gas assets. We require these businesses to be both fundamental to the industry and hard to replicate.

Our unique stand-alone investments are selected by reference to the product or service they provide. They must operate in an attractive industry, exhibit high barriers to entry and earn attractive returns on invested capital.

In an overarching sense our investments share a common goal - great management, a clear addressable opportunity, low levels of debt and high barriers to entry. Moreover, we prefer our investments to operate with a favourable tail wind, and exhibit growth above global GDP. This will provide the best opportunity to outperform the market over the long term.

Critical Infrastructure - Payment Processors
Shift from cash to cashless

Payment processors provide the rails on which transactions are carried, processing hundreds of billions of transactions totalling trillions of dollars each year. The rails are made available to thousands of banks worldwide to facilitate payments for merchants and consumers.

Australians are familiar with the 'tap and go' payment system in Australia, but few people realise we lead the world in this technology take-up. The growth in contactless payments is driving a secular shift from cash to card. MasterCard estimates only about 15% of all retail payment transactions globally are currently made on card, which sets up a strong structural tail wind for our investments in payment processors. This tail wind ensures steady volume increases that will play out over the next decade.

Critical Infrastructure - Oil and Gas
Growth in gas demand

For decades, coal has been the dominant energy source for generating electricity in the US. However, the Energy Information Administration (EIA) is forecasting 2016 will be the first year natural gas generation will exceed coal generation.

Our investments in midstream oil and gas assets span complex refining, NGL fractionation, storage and transportation. We have chosen to invest in the infrastructure in preference to the underlying commodity.

The recent rout in oil and gas prices created an opportunity to acquire these assets at good prices. Although we cannot predict the path of future oil and gas prices, we know our investments are crucial to the efficient functioning of the industry. Importantly, the recent price volatility was a supply led rout. The demand outlook for both oil and gas and their by-products is largely unchanged. This means our businesses will transport greater volumes of gas on their network and refine more oil at their refineries. As oil prices normalise over the coming years, we expect these businesses to take a larger percentage of the value chain within this industry.

Critical Infrastructure – Agriculture
World population growth and emerging middle class

The global population is tipped to grow to more than 9.5 billion people by 2050. It is also expected the population will enjoy higher living standards and diets will include more grain intensive foods such as meat. The worldwide demand for grain (corn, rice, soybeans and wheat) has climbed steadily in recent years and is up approximately 40% since 2003. To facilitate these growth objectives, the industry will require investment in agricultural land, crops and equipment.

In comparison to the strong growth years of farm economies earlier in the decade, the current downturn has been dramatic. Since peaking in 2013, industry sales of large agricultural equipment in North America have fallen 60%. While it is impossible to forecast a recovery, we believe the current depressed prices represent a good entry level for investments held over the next five years.

The current technological advancements with respect to precision farming aided by GPS systems has driven a demand for new machinery. We are optimistic this theme will play out over the next decade and reinforces our investment in the segment.

Critical Infrastructure – Cloud
Shift to the cloud

The cloud war today is being fought on two dimensions, the cost to compute (processing) and the cost to store (storage). We have seen this market dominated by Amazon, which has cut its price more than 50 times over the last few years. However, fighting a war on price is only fun for so long. The market has become overly enamoured with size, and we expect the next phase of the battle will be fought on value and innovation.

By innovation, we mean opportunities for users to build and deploy applications in significantly less time. The cloud of the future will need to be a platform for innovation. This theme is early in its evolution and we expect it to play out over the next five years.

We expect the public cloud to grow rapidly but also anticipate development of a hybrid cloud, an integrated cloud service utilising both private and public cloud. For example, companies might use a public cloud for email and workflow applications but house financial and other sensitive data in a private cloud. IBM is specifically focused on the hybrid cloud and we believe it can prosper in this arena.

Stock In Focus: IBM

After stringing together 16 quarters of negative growth, IBM's share price has retreated nearly 50% from its 2012 high. We have accumulated a position over the last 9 months and IBM now represents 10% of the portfolio.

The share price decline has been driven by rationalisation in low return verticals and decline in large scale ERP implementations. In a nutshell, their core business is shrinking, and their new businesses are growing. The market is waiting for the inflexion point. However, we think about investments based on intrinsic value and believe IBM's value is significantly higher than the current share price.

We would not be surprised to see earnings per share move lower over the next 12-18 months. However, our valuation of IBM is around $225. In a downside scenario we value the company at $150. We like companies where the payoff is asymmetrical and IBM is such a company.

Our portfolio has been assembled for the long term. We are happy to wear short term underperformance so long as we acquire great businesses at low prices.

Reinvention

IBM has been ushering in a new wave of growth – what they refer to as their strategic imperatives. They include analytics, cloud, security, mobility and social. These strategic imperatives represent 37% of total revenue and the two topical growth areas are Cognitive Computing and the Internet of Things.

Cognitive Computing

A cognitive computer is a misnomer. It is not a computer, rather an array of sophisticated algorithms that interpret and understand data. But why is this important?

Today the largest natural resource is data and as it proliferates, the need to process and understand it increases. This drives a requirement for computers that understand, not just process large volumes of data. A cognitive computer can ingest large quantities of unstructured data enabling it to reason and learn.

Traditional computers are very good at computations as the name suggests. However, they require data to be structured in a pre-defined manner, like a database. The problem, however, is that 80% of data is unstructured, which includes things such as news articles, research reports, social media posts, images and video. To date this information has been unable to be processed by traditional computers.

IBM have developed a platform to deal with unstructured data, called IBM Watson. Watson is a cognitive computer that can understand natural language, images and video, which has many real world applications.

In healthcare, Watson is being trained using 30 billion images including X-rays, CT scans and MRI scans that could help diagnose ailments like cancer and heart disease sooner. At Medtronic, Watson has been able to predict a hypoglycaemic event in a diabetic three hours before it happens.

Watson's increasingly advanced cognitive abilities may redefine standards and practices in the health-care industry. IBM believes $2 trillion is wasted in health-care spending and estimates the total addressable market for health and life science solutions to be about $200 billion.

Internet of Things

The second growth area is the Internet of Things or IOT which is a network of sensors that collect data. For General Electric (GE), it is the thousands of sensors that pull large amounts of data from a jet engine, an MRI scanner or gas turbine.

You can quickly see that this will lead to an explosion of data. The next decade will see the evolution of the IOT.

IBM has chosen to focus on the infrastructure – which caught our attention. The growth in data will create two needs. The need for a reliable cloud based platform that can handle billions of enquiries per second and sophisticated analytic capability to process the data (Watson).

Their acquisition of The Weather Company brings a platform that handles 100 terabytes of information ingested per day, from 2.2 billion locations handling 15-26 billion API requests per day. In short this is a platform that scales and is the class leader in IOT. Other opportunities in separate verticals include oil and gas, retail and healthcare to name a few.

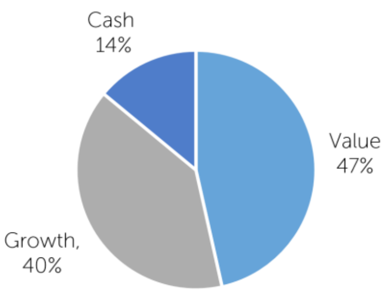
IBM Summary

At the age of 105, IBM has weathered many storms as it reinvented itself a number of times. From tabulators to giant disk drives, mid-range personal computers or mainframes. The product changed but the script was the same. We are betting IBM can reinvent itself again with cognitive computing and IOT.

Value and Growth investments

We think about our companies as either value or growth. Our growth investments tend to trade on higher multiples and to some extent have favourable characteristics which the market appreciates. Our value based investments are generally out of favour and carry greater upside but also a longer term payoff.

We made a deliberate pivot from growth to value investments over the last six months. This has seen us exit a number of positions trading at prices approaching our estimate of intrinsic value to acquire businesses with a greater margin of safety.



From 2012 to 2016, the S&P500 Total Return Index increased 68%. If you had invested $1 in 2012 it would be worth $1.68 in 2016 inclusive of dividends. We can disaggregate the return into two components:

- Investment returns: the return attributable to an increase in earnings per share and dividends. These returns have provided steady underlying performance over a long period.
- Speculative returns: the return attributable to the increase in the multiple paid for those earnings (price-to-earnings ratio). The speculative returns on stocks represent changing public opinion about stock valuations. Price to earnings ratios tend to rise and fall as investor sentiment about the economy's future prospects changes and these are anything but steady.

Between 2012 and 2016 the price-to-earnings ratio on the S&P500 expanded from 14x in 2012 to almost 20x in 2016. This change represents an increase of 42% and is the speculative return. The balance of the equation is the investment return totalling 26%, a combination of earnings per share increases and dividend yield.

Said another way, if you own a private business that earns $100,000 per year, the market would have paid $1.4m (14x multiple) for the business in 2012 and $2m (20x multiple) for the same business (assuming earnings remain at $100,000) in 2016.

The graph below highlights the price-to-earnings ratio of the S&P500 from 2012 to 2016. You can see the expansion in multiple as investor sentiment changed over the period.

Why we increased the weighting to value stocks

Our growth oriented investments have experienced a significant increase in the multiple paid for each dollar of earnings. While this is positive for short term returns it raises the portfolio risk over the long term. Moreover, we were concerned about the valuation premiums on some of those investments.

As a result of the expansion in growth multiples, we have chosen to pivot our assets toward value based investments, and our portfolio fundamentals have improved markedly as a result. The most notable metric is the increase in dividend yield (up to 2.59% from 2.19%) in addition to a meaningful rise in book value per share.

A by-product of this shift will be the potential to underperform in the short term. Our largest value based investments are trading at significant discounts to our estimate of their intrinsic value. However, the timing of their recovery is uncertain. The market eschews uncertainty but it provides long-term investors an opportunity to acquire quality businesses at discount prices. The corollary is that we may underperform the market over the next 12 months.

This pivot may impact our short term performance, however we are confident this decision will be vindicated in our 3 and 5-year performance. Currently our top five holdings are:

IBM	10%
Phillips 66	10%
Visa Inc	6%
Microsoft	6%
PayPal	5%

In terms of our portfolio concentration, our top 5 holdings account for 37% of the portfolio and our top 10 holdings account for 57%. Both percentages increased over the period.

Outlook

Our view has not changed over the past few years, and we continue to believe we are in a low growth world where global equities remain attractive relative to other asset classes.

Equity investments should be made with reference to the risk free rate, generally accepted to be a 10-year government bond. Today, the return on a US 10-year bond is around 1.46%. If you held the bond for 10 years, it would produce a return approximately equal to 1.46% per annum.

Our portfolio of high quality global equities produces a 6.33% earnings yield. The dividend yield, which we expect to grow over time is 2.59%, nearly twice the 10 Year bond rate.

Global unemployment has been steadily declining since 2009 when it peaked at 6.2% and is now just 5.5%. OECD countries however show a bleaker picture with their unemployment rate at 7.5%. With unemployment back to pre-recession levels, what has changed? In a word, debt.

A McKinsey report noted that global debt has increased by $57 trillion (McKinsey Global Institute, Debt and Deleveraging, Richard Dobbs et al, February 2015). The three identified areas of emerging risk are (a) the rise in household debt (b) rise in home prices and (c) quadrupling of China's debt, fuelled by real estate prices and shadow lending.

With interest rates at near zero and negative in quite a few developed economies, the traditional returns achieved on equities must moderate. If you look at the return on equities over the last 100 years, they typically produce a nominal return of around 10% per annum. We believe market expectations around returns needs to be rebased. Accordingly, we are targeting lower returns as a result.

Accommodative central bank policies across the world are not delivering the desired response – a return to above trend growth. Instead monetary policy is leading to economic distortions and while these distortions prevail and volatility remains a feature, we believe it prudent to maintain a higher cash balance to take advantage of the volatility.

Fortunately, our investment strategy does not rely on us picking the path of any economy. Our businesses are exposed to favourable tailwinds and will prosper over time. Although expectations and the impact of monetary policy are important, we don't believe they are knowable. Therefore, we will continue to focus on the selection of outstanding companies exposed to favourable long term trends.