11th October 2018

2018 Financial Year

Performance Measures

2018

For the 2018 financial year, the Trust delivered a return of 17.01% before Performance Fees (PF) and 15.42% after Performance Fees. A summary of the Trust's performance is provided below, with further commentary included in the Operating Review.

		Unit Price	Return
01-Jul-17		$3.3325	
30-Jun-18	Before PF	$3.8995	17.01%
	After PF	$3.8465	15.42%
Distribution per unit		$0.1181	
Closing unit price		$3.7284	

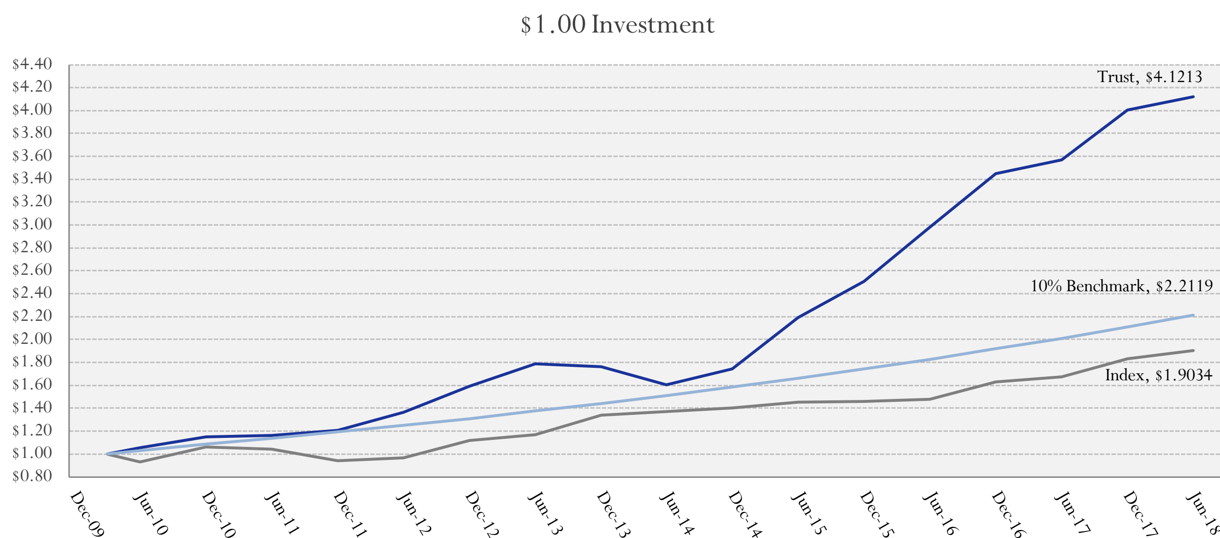
As detailed in the Operating Review, the Trust has made a distribution of $0.1181/unit for the 2018 year. Following payment of this distribution, the closing unit price at 30 June 2018 was $3.7284.

Historical Performance

Below is a summary of the annual percentage change of the Trust (both before and after Performance Fees) against the 10% Benchmark and the All Ordinaries Accumulation Index (Index) – the Trust's return for 2010 relates to the period from commencement on 2 March 2010, with the Benchmark being adjusted accordingly. The All Ordinaries Accumulation Index is used because it is the broadest measure of the Australian share market's performance whilst also including the effect of dividends.

	Blue Stamp Trust				Variance
Year	**Before PF**	**After PF**	**Benchmark**	**Index**	**(Trust vs Index)**
2010	7.2	5.6	3.2	(7.3)	12.9
2011	10.3	10.1	10.0	12.2	(2.0)
2012	27.0	18.5	10.0	(7.0)	25.5
2013	50.6	30.4	10.0	20.7	9.7
2014	(10.8)	(10.8)	10.0	17.6	(28.4)
2015	36.9	36.9	10.0	5.7	31.2
2016	43.5	36.7	10.0	2.0	34.7
2017	20.8	19.6	10.0	13.1	6.5
2018	17.0	15.4	10.0	13.7	1.7
Avg Annual Return	**23.0**	**18.5**	**10.0**	**8.0**	**10.5**

The following graph tracks the change in value of $1 invested in the Trust versus the 10% Benchmark and the Index. The value of the investment in the Trust is after all fees and *includes* the reinvestment of any distributions.



Viewing the return of the Trust against the Index should only act as a supplement in understanding the performance achieved in the prevailing climate. Instead, our main concern should be focused toward beating the 10% Benchmark over the medium term, by an acceptable margin.

As mentioned in prior letters, given that we are investors seeking longer term capital growth, we should eschew the short term and focus on performance over time horizons that are consistent with the period of our investment. Accordingly, expanding our perspective to include the entire operating history of the Trust, an investor at the Trust's commencement would have received an average annual return of 18.53% (after all fees).

While a longer span of time helps reveal the merits of our investments, we nonetheless report over much shorter time frames. Accordingly, to best equip ourselves for the short term, we should be prepared for negative years, which I fully expect the Trust to experience in the near term given the buoyant markets that are prevailing.

Manager Remuneration

Fee	**Description**	**2018**	**2017**
Performance Fee (paid as)	Cash ($)	129,742	50,806
	Units ($)	147,109	88,522
	Total ($)	276,851	139,328
Management Fee (paid in cash)	Amount ($)	159,941	99,377
	% of net asset value	0.968%	0.987%

Amounts reflect the expense to the Trust – inclusive of Goods and Services Tax (GST) and Reduced Input Tax Credits (RITC).

The value of the Performance Fee was determined by the extent of the Trust's performance that exceeded the 10% benchmark. Importantly, with the Management Fee Rebate in place, the full amount of the Management Fee paid over the year has been applied to the gross Performance Fee of $430,040 (excluding GST), to reduce the Performance Fee payable for 2018 to $270,099 (excluding GST).

For 2018, the rate of this Management Fee was 0.968% of the average net asset value of the Trust. While this is below the limit of 1.025% (including GST and RITC), there is still considerable work to be done to reduce it further.

To meet the tax liability generated from the payment of the Performance Fee, a portion of this fee is paid in cash. However, in no way does this cash payment reflect any wavering of Blue Stamp's key tenet of building an alignment of interests between the Manager and Unitholders. Instead, having the 'after tax' component of the Performance Fee being paid in units, continues to underscore the Manager's commitment to the long-term performance of the Trust.

No amounts other than those stated above were paid to the Manager from the Trust's assets over the year.

Since moving the administration of the Trust to Mainstream Fund Services, you may have noticed a clarification of the Class of your units in the Trust (most likely being 'Lead Class'). This represents a continuation of the series pricing approach followed by the Trust, however now using Mainstream's processes, terms and references. Practically, this approach means when an investor enters the fund part way through the year, series pricing allows for that investment to be given its own class of units, so that the management fee and performance fee can be levied on the actual investing experience. If by the end of the year, this newer class of units has earned a performance fee, it will then be consolidated into the Lead Class of units (being the oldest class of units on issue to have borne a performance fee) for future financial years. If no performance fee has been earned on the newer class of units, then it will remain its own distinct class, until such time that a performance fee has been earned on those units. This series approach followed by the Trust is considered the most equitable way to calculate performance and levy fees in a pooled structure where investors are able to enter and exit the vehicle at various times throughout the year. While there is a great deal of complexity in this series pricing, the tradeoff is equitable treatment between investors – sometimes simple isn't always best.

Operating Review

Income

The most significant components to the Trust's performance, are the change in value of our long-term investments (both realised and unrealised) and any dividend income the Trust might receive. A summary of the Trust's income during the year is shown below.

	2018	2017
	$	$
Investments - Realised	1,702,629	565,909
Investments - Unrealised	1,323,026	1,145,655
Dividends	200,136	125,634
Other Income	9,076	4,460
Gross Income	**3,234,867**	**1,841,658**

Investments

While the Trust's performance of 15.4% for the 2018 year was modestly below the average return it has generated since commencement, it's nonetheless a result that belies the challenging nature of the year. Candidly, the Trust has never experienced such tough investing conditions, a symptom of which can be seen in the spike in income produced from realised investments during the year – and my first grey hair.

The challenges came at either end of the performance spectrum and were completely consistent with commentary from last year. That is, after waxing lyrical in the 2017 letter about our investment in the data centre group, NextDC, and the challenges being faced by another of our holdings, Silver Chef, the 2018 year saw both investments continue to hurtle along their respective trajectories.

That is, enjoying significant structural tailwinds with the growth of cloud computing, NextDC (NXT) delivered strong operational results that showed the Group was capitalizing on this tectonic shift very well. With NXT's earning power becoming increasingly recognised by the market, NXT's stock price was well supported. However, for one of the first times in the Trust's history it begun to appear as though continuing to hold our position in NXT might weigh on our future returns, based on the run up in price. Accordingly, we made a difficult decision and begun to reduce our holding – driving the increase in realised investment income.

Having the ability to look deeper into time can be a great advantage when investing in assets that are quoted on a moment to moment basis, however it can also present enormous challenges, which the Trust was certainly confronted with during 2018 from its investment in Silver Chef (SIV). That is, unlike NextDC, Silver Chef was dealing with structural decay, which was made even more painful by the leverage that underpins their capital structure – a common trait of almost all financial service companies. These issues were very clear in the 2017 annual report it published in August 2017, showing a spike in its receivables and a deterioration in the level of provisioning against them. This spelt trouble for the Group in the near term, as growing arrears leads to returned and impaired assets, higher impairment charges against those assets, along with increased costs in repossessing, reconditioning and remarketing those assets. This unpleasant outlook led us to sell a material portion of our holding. However as the stock price begun to fall, being an investor with a longer term outlook, I was drawn to 'look through' many of these issues as being more transitory – given they related to a marginally profitable

subsidiary that was receiving less capital and less of management's attention. Conversely, the Trust's investment in SIV was built off their core hospitality offering, which had superior underlying characteristics, such as:

- customer trading activity that is structurally better suited to servicing a loan than their non-hospitality customers;
- hospitality is an asset pool that is too niche to attract the large lenders (reducing the competitive landscape), but not so niche that there isn't a meaningful secondary market for the Group to remarket the asset back to;
- generating far superior returns on capital; and
- having demonstrated a growing stream of earnings (over decades).

The challenge for the fund came when trying to reconcile what I considered to be longer term value with the possibility of near-term price weakness as they worked through the bad book of assets (which have an average contract life of 24 months). How a long-term investor that sees longer term value, reconciles possible short-term operational headwinds in an asset that is being continuously traded, is a deeply difficult question to answer (for me anyway, given my history of profoundly poor timing (across all areas) – investing, punctuality, comedic, romantic – it's a miracle I've got a wife!). Accordingly, as SIV's price weakened and it looked like more value appeared, I was drawn to purchase more. However, each time the stock fell, making it look cheap, the company would produce results that justified the reduced price.

Companies in structural decline always look cheap so long as you fail to recognise they're in structural decline. After this realisation though, it's probably far too late to protect the value of any capital already invested and far too difficult to pay a low enough price to earn a decent rate of return on any new capital committed. Mix financial leverage into this equation and the difficulties compound. This is a risk that the longer-term investor is far more exposed to than any other type of investor and an attribute that weighs heavy with responsibility. Which brings me (again) to the huge challenge that was the fund's 2018 investment in SIV. That is, while it is a tremendous advantage to being able to look deeper into the future and make decisions with the strength of patience – and invest according to the inertia of earnings, rather than the instance of earnings – we nonetheless remain exposed to adverse short-term price movements, which are manageable, provided your assessment around the longer-term earnings and their durability is correct. Certainly in the case of SIV, my preference to 'look through' resulted in flat footedness in steering the Trust away from near term troubles. Combined with an overestimation of short-term operational performance in the core hospitality division, the Trust carried a holding in SIV that weighed heavily on our 2018 performance. While the Trust still has a position in SIV, it has been greatly reduced in light of the Group's obscured outlook.

Early in the 2018 calendar year, the Trust begun to build a position in Afterpay Touch Group (Afterpay or APT). Afterpay effectively provides an outsourced lay-by service to retailers – allowing the retailer's customers to purchase an item, receive it now and pay it off over four equal fortnightly payments. APT's product has resonated very strongly (certainly initially) with the younger demographic, who are typically more wary of using credit cards but are still looking for easy, flexible ways to fund 'life's little extras'. Refraining from charging any rate of interest on the purchase, APT prides itself on not 'making money off its customers'. Instead APT is paid an amount from the retailer (typically around 4% of the purchase price), for completing the transaction. Historically, APT's intermediation has proven to be a genuine value enhancer for retailers, as they have found their order completion rate rises for those customers using APT, whilst at the same time increasing the basket size. Blue Stamp had been notified of the merits of APT a number of years ago but was not suitably moved enough to hand over Trust capital for APT shares – a lack of action I now rue. However, having watched from the sidelines for some time, our chance came again earlier this calendar year when APT received some unfavourable media coverage, causing the stock to swoon, despite the Group continuing to deliver outstanding operational performance. Rarely do intermediaries accomplish little more than clipping a ticket, so with a globally relevant product and one that has proven (in Australia and New Zealand) to enjoy very strong brand recognition and network effects, I expect the Trust will be holding these APT shares for a very long time.

Given that we are investors seeking longer term compounded growth, it is important that we have regard for the scalability of the investment returns being achieved. Having regard for the possibility of geometric progression in the capital invested, it's been clear for a while that we would need to broaden our horizons beyond Australia. Accordingly, on 30 September 2013 the Trust converted some AUD into USD in order to build our skills and experience in this much larger pool of investments, and so too, the longer-term scalability of our investing – though it wasn't until March 2014 that the Trust purchased its first US listed share. With the proportion of Trust assets invested abroad continuing to grow, it is increasingly important that these figures are broken out of our results, to ensure we can monitor the effectiveness of the capital allocation decisions.

The table below shows the performance of the Trust's US portfolio against the total assets of that portfolio. In calculating this return, brokerage charges have been included, however foreign currency movements, interest expense, management fees and performance fees have all been excluded. Also, to provide some context around the materiality of US returns on the Trust's overall performance, the composition of the Trust's portfolio invested between US and Australian markets is shown. The longer-term rationale behind our international holdings is described further in the General Discussion section.

	Return on USA	**Portfolio Composition**	
Year	**assets (%)**	**USA**	**AUS**
2014*......................	1.1	0.8	99.2
2015......................	7.6	0.8	99.2
2016......................	6.4	0.3	99.7
2017......................	22.0	3.0	97.0
2018......................	28.9	15.2	84.8

*for the period 11 March 2014 to 30 June 2014

Dividends

The increase in dividend income in 2018, stemmed from larger holdings in existing positions. Consistent with Blue Stamp's focus on generating capital gains (rather than dividend income), the underlying businesses we own are also reinvesting a large portion of their profits in order to further develop their operations and grow their profitability. This naturally restrains the total value of dividend income the Trust receives.

The dividend income shown above does not include franking credits.

Expenses

	2018	2017
	$	$
Investing Expenses		
Brokerage expense	(28,975)	(24,830)
Interest expense	(76,120)	(61,751)
Other expense	(1,363)	-
Total Investing Expenses	**(106,458)**	**(86,581)**
Management Expenses		
Management fee	(159,941)	(99,377)
Performance fee	(276,851)	(139,328)
Total Management Expenses	**(436,792)**	**(238,704)**
Total Expenses	**(543,250)**	**(325,285)**

Investing Expenses

Investing Expenses are costs that relate directly to securing and holding the assets of the Trust, of which drive the investment returns achieved.

The Trust received some relatively large contributions of new capital during the year, which when invested led to the increased brokerage expense incurred. Also contributing to the increased brokerage expense was the increase in trading activity that occurred due to the developments in the Trust's holding in NextDC and Silver Chef, as mentioned above. For 2018, the average rate of brokerage paid on each transaction was 0.090% (2017: 0.141%), with the material reduction occurring following the Trust moving all execution to Interactive Brokers.

Also contributing to the higher investing expense was an increase in borrowings the Trust carried throughout the year, which corresponded to an increase in interest expense. The borrowings were incurred through a margin lending facility. The reason the Trust uses a margin loan is to allow it to maintain a fully invested portfolio – provided individual opportunities justify it – however it is the Manager's intention to limit the borrowings to a 25% ratio against net asset value. With the stock market rising on average over long spans of time, a fully invested portfolio (i.e. zero cash and zero borrowings) is our preferred state, with the margin loan providing increased liquidity when we feel the circumstances warrant the increased exposure and higher cost of funding. Obviously though, the market's performance in any one period may vary wildly, which is the reason for our relatively conservative borrowing limit. Certainly, when borrowings are used to finance an investment it is done with a clear understanding of the Trust's ability to service those borrowings through various market cycles and operating conditions, along with how the borrowings will be managed and paid down over time.

At year end the Trust's borrowings (net of cash and liabilities to be settled by way of issuing units – such as performance fee, subscriptions received in advance and distributions) were at the upper limit, representing 24.3% of net asset value (2017: 22.8%). Over the year, the Trust carried average borrowings of 14.3% of net asset value (2017: 13.1%).

Management Expenses

The Management Fee is the fee charged to manage the operations of the Trust, with any amount paid being rebated back against any Performance Fee accrued. If, over time, a Performance Fee is being earned by the Manager, then with the rebate in place, the only fee Unitholders should effectively be paying is the Performance Fee – with any amounts paid under the Management Fee acting like an advance on any future Performance Fee. This helps ensure the Manager of the Trust will be adequately resourced whilst at the same time, maintaining the commitment to minimising the drag of any management expenses on the Trust's performance.

With the performance of the Trust being calculated after the payment of any Management Fee, it is in the interests of the Manager to keep any Management Fee as low as possible, as a lower Management Fee will lead to a greater return for the Trust and naturally, a higher Performance Fee.

The ratio of the Management Fee paid for 2018 as a proportion of the average net asset value over the year was 0.968% (2017: 0.987%). While this was below the 1.025% limit (including GST and RITC), there is considerable work to be done to reduce it further.

By virtue of its structure the Performance Fee will only become payable when the Unitholder's equity (measured on a per unit basis) has increased by more than the Benchmark of 10% p.a. Following on, this fee would rightfully be considered a success fee as it represents the creation of absolute wealth for Unitholders.

As a large component driving the value of the Performance Fee was unrealised gains, an important feature of the Trust is that the 'after tax' amount of the Performance Fee is paid in units of the fund. This keeps the Manager 'on the hook' for the quality of the Trust's investments and therefore aligned with the interests of Unitholders.

Operating Profit

	2018	2017
	$	$
Gross income	3,234,867	1,841,658
Total expenses	(543,250)	(325,285)
Net Operating Profit	**2,691,617**	**1,516,373**

In line with the earlier discussion, the net operating profit for 2018 led to a 15.42% rise in the unit price to $3.8465

General Discussion

Returns vs Returns

When there is a material figure shown in the realised investments line in the income statement, it signals that something has gone awry. That is, we will only get material figures in this line item when one of the following has occurred:

- there's been a takeover;
- an investment has become overvalued;
- an investment has structurally deteriorated; or
- we have run out of money and are forced to recycle capital between our ideas.

In the past 24 months, the Trust has dealt with all four. Simplistically, all of these (possibly barring the last one) will weigh on the Trust, either immediately or in the future. So when you see a spike in the 'realised income' line, light a candle for our returns.

On this topic of realising investments, it's worth noting that not all returns are created equal. That is, the Trust's 15.4% for 2018 has come with $0.118/unit of taxable income. Simplistically, if an investor has a tax rate of 30%, their post-tax return for 2018 will be reduced to 14.4%. By contrast all of our highest year's returns (30.4%, 36.9% and 36.7% in 2013, 2015 and 2016 respectively), were not accompanied by any distribution as they did not generate a single dollar of taxable income for investors to pay as our returns were being driven by unrealised gains, and so were far higher quality than every other year's performance.

If compound is the objective, but instead of generating it through long term unrealised gains, it is achieved from consistently realising the positions, then any investor in that fund will experience a yearly 'leakage' of their performance to the tax office, which will only grow more significant over time. If this investor is also reinvesting their distribution, they will likely find it increasingly difficult to keep paying the tax liability generated each year, forcing them at some point to elect to receive cash distributions, which will likely weigh on their overall performance as the capital will presumably be deployed into lower returning investments.

However, a patient investing philosophy allows for gains to be built on gains, without having to give up a slice to the tax office. So not only is compound working for us, but compound is working on an interest free, non-callable, deferred tax 'loan' from the government, making an even more powerful compound machine. Assuming away the ability to deliver compounded returns (which is an absurd assumption given how unlikely they are to occur over long spans of time) the importance of these concepts of 'unrealised income' and 'compounding deferred tax' could not be overstated. Again, not all returns are created equal.

Sustainable and Scalable Returns…?

With an objective to deliver compounded returns, the investing needs to be both sustainable and scalable – so that the process followed to deliver historical returns remains largely consistent with that which may be followed in the future, as larger sums are deployed.

Accordingly, as the Manager of the Trust, Blue Stamp has always had at its core a focus on the patient allocation of capital – though the type of company Blue Stamp is looking to invest that capital with has changed over the past eight years. In its earlier years, Blue Stamp was initially looking for cheaper companies, which were typically characterised by lower quality operations (and earnings) and lower valuations. We would then realise the position once it had appreciated and then re-invest it into another similar opportunity – effectively 'manufacturing' the compound ourselves. This approach was possibly a natural side-effect of emerging from the financial crisis, where everything was incredibly cheap. However it became quickly evident that these companies didn't have very strong competitive positions or durability in their earnings – as their profits either weren't growing or were very volatile. It was an approach that would not scale well with the size of capital deployed as

larger and larger numbers of companies are required to invest in, with a greater amount of time being spent on order execution. As mentioned above, it will also incur higher transactional costs and taxes. While these are all factors that any investment manager has to deal with, for an investment operation with a shorter dated horizon they would begin to weigh on performance at far smaller fund sizes. If Blue Stamp was to deliver compound returns, then it would likewise need to find companies that were able to compound themselves.

On pursuing this path further (that is, looking for higher quality companies but still trying to buy them 'cheaply'), it became clear that the concept of margin of safety was a very 'layered' one. That is, (simplistically) a margin of safety comes from buying a company for less than it's worth. However digging deeper, it appeared that this simplistic idea of a margin of safety was incomplete. That is, in reality an investment's margin of safety was built from many layers, such as;

1. a margin of safety in the research undertaken (wanting to know more than the marginal investor),
2. a margin of safety in the growth in earnings (growing earnings will provide far more protection to the principal invested than static or declining earnings); and
3. a margin of safety in the tenor of holding (the longer the tenor, the higher the margin of safety).

The 'research margin of safety' is the most important of the three layers and is essentially what delivers the 'simplistic margin of safety' (buying a company for less than its intrinsic value), as it informs what the likely future earnings of the company may be and what an appropriate price to pay for access to those earnings should be. Accordingly, having far more regard for the qualitative aspects around a company's operations, whilst trying to find 'compounders' to deploy capital in for long stretches of time meant our investing gravitated toward those companies that had a durable differentiation and bent to innovate – affording them the ability to deploy increasing amounts of capital at equivalent rates of returns, leading to a stream of growing earnings. If those last attributes sound familiar, they should, because that is exactly what the Trust is trying to achieve. Accordingly, hitching the Trust to 'compounders' (and keeping it there), seems to be a sustainable and scalable way to deliver our own compound.

However, even with a focus on longer-dated investments in higher quality companies, it was still clear that with a long-term compound objective, Blue Stamp could quickly out-grow the opportunities available in Australia – indicating the importance of markets outside Australia. Though with such large and wide opportunities available internationally there was the potential to be undisciplined – that is, with a long-dated investment approach should Blue Stamp have regard for investing in those markets displaying the highest return opportunities, such as India, China etc? Or should Blue Stamp remain in developed markets with similar economic, political and legal systems as Australia, such as Britain, Canada etc? Blue Stamp decided on the latter, to focus on those developed markets with proven economic, regulatory, legal and political systems. However again, recognising the influence of concentration on performance, Blue Stamp decided to focus primarily on one region – the region most similar to Australia whilst also offering the largest opportunities; USA.

Recognising this was a problem that was probably 20 years away (and one which would only exist, should Blue Stamp be successful – in terms of average annual after-fee returns), the approach to allocating capital into markets outside Australia was gradual (as shown in the earlier table). For a number of years following this first purchase, Blue Stamp did not add to its US listed portfolio, instead focusing on familiarising itself with the local reporting framework and organically researching various companies. Early in the 2017 financial year though, more capital was allocated to the US portfolio, modestly building the proportion of the Trust's assets invested in US listed shares to 3.0% of total assets. Now with more experience in investing in the US market and having identified opportunities that were consistent with Blue Stamp's investment objective, larger amounts of capital, have been deployed into US listed companies during the 2018 financial year.

While there was a spike in the proportion of the Trust's assets invested in US listed shares during 2018, it is not expected for there to be another equivalent increase. There remains many years of growth in Australian

opportunities, so the size and importance of the US listed portfolio will continue to be built over time, driven by the attractiveness of opportunities as they are identified.

Whilst this approach was designed to help build the scalability in the investment returns being achieved, it was also a risk mitigation strategy. That is, this gradual approach could help prevent the situation, perhaps many years in the future, where the domestic opportunities have been exhausted (which hinges on the huge assumption that we have been able to continue to compound), necessitating us to dramatically redirect our focus to new, foreign markets. This redirection in our focus would likely occur at a time when the Trust would never have been bigger and the Manager's knowledge of foreign markets remaining undeveloped – effectively compounding the risks. Our gradual wading into the US market in 2013 was an effort to mitigate this potential longer-term risk and instead build scalability in the investment returns being achieved.

Luke Trickett

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