

30<sup>th</sup> August, 2011

## 2011 Financial Year

### Performance Summary

<b>Unit Price - at 30 June</b>	<b>2011</b>	<b>2010*</b>
Before Performance Fee	\$1.1650	\$1.0721
After Performance Fee	\$1.1635	\$1.0563
After Performance Fee & Distributions	\$1.1374	\$1.0563

### Trust Return - 1 July to 30 June

Before Performance Fee	10.29%	7.21%
After Performance Fee	10.14%	5.63%
Trust Return to Date - after Performance Fee	16.35%	5.63%

### Index Return - 1 July to 30 June

All Ords Accumulation Index	34,117.52	30,415.16
All Ords Accumulation Index Return	12.17%	-7.27%
Return to Date	4.01%	-7.27%

Performance Fee	\$604.87	\$1,263.66
High Water Mark - 30 June	\$1.1374	\$1.0563

\*The returns for both the Trust and Index for 2010 are calculated from 2 March 2010 – the start date of the Trust.

### Commentary on the Trust Performance

In my 2010 letter, I mentioned briefly some developments in the European financial situation that had occurred at the time and how fears over this situation had caused some large movements in the markets of which we were able to exploit and scoop up some shares in wonderful businesses. For 2011, humorously enough, I could write nearly the exact same thing, however, make the swings much larger and so too our purchases of shares. It puzzles me how the markets can be so focused on the short term that effectively a situation can exist today in much the same form as it did yesterday or even last year, only for it to elicit a much more potent response now. I guess it probably comes down to perceptions and how your perceptions influence your actions. I think this also reveals something else though, that our perception of a situation, of which this situation may be inherently very long term in nature (such as the valuation of businesses or the presence of a large amount of debt sitting on some European governments balance sheet) are greatly influenced by the short term environment, creating a disconnect between reality, perceptions and then actions.

In light of the unprecedented state of global finance I have included a description of my thoughts on the matter. If you are in any way interested then please feel free to read the section 'A Description of the Current Economic Climate'. However, if you are not that way inclined, of which my wife

could sympathise only too well with, then feel free to use as lining for your bird cage or any other suitable use.

While this approach is not something I would normally follow, given however the significant market movements that have occurred recently and most notably after 30 June 2011, I have included a more up to date unit price for your reference.

Unit Price* at 18 August 2011	\$1.1541
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\* This unit price is after all imputation credits for the 2011 financial year have been returned and after provision for any performance fee that may have been accrued up to this date.

Your manager views the performance of the Trickett Trust (Trust) during 2011 as a satisfactory result, perhaps a C+. The main drivers of the Trust's performance were the arbitrage operations and the receipt of dividends. Some arbitrage events worthy of mention which the Trust participated in was the acquisition of Mosaic Oil early in the 2011 financial year as well as the sale of Centennial Coal to a Thai coal mining and power company. The acquisition of CPI in another takeover deal was made interesting through the structure of the scheme, whereby the bidder agreed to pay a significant portion of the consideration as a fully franked special dividend, which is not the typical path for transactions of this nature. The Trust was however caught in the failure of the Redflex bid to complete. This was something that affected me deeply as the defeat of the transaction seemed only to be motivated by the corrosive effects of human ego.

On a brighter note we continue to receive good dividends from our investee companies. Throughout the year we took advantage of times when fear ran through the markets, to further increase our ownership in these companies and in turn the amount of dividends received. While the results and performance of these long term companies has been somewhat affected by the challenging economic environment, they have none-the-less performed well and their fundamentals remain very sound.

In recognising the contribution of dividends to the performance of the Trust I would like to specifically describe the approach followed by the Trust in recording imputation credits as an asset of, and income to, the Trust.

Imputation credits can be generally described as a credit for tax already paid on distributed profit, where the recipient can use those credits to offset against their tax liability that arises from the receipt of that profit. This effectively removes the double taxation of the distributed profit. Accordingly, by including these imputation credits as income, the profit received is 'grossed up', to reflect the amount of profit before any tax had been paid. The credit is then separately applied as an offset or rebate when determining any tax liability (or refund) by treating the imputation credits as tax that you have effectively already paid, similar to PAYG that employers withhold in respect of employees.

For example, if a company makes \$1,000 profit and pays tax at a 30% rate (i.e. \$300), it will be left with \$700 to distribute as a dividend. When distributed to the shareholder, this profit would have two components, being \$700 in income and \$300 in imputation credits. By adding the imputation credits back to the income, the dividend is 'grossed up' to reflect the value before any tax was paid on the profit, being \$1,000.

Following on from the example above, the receipt of imputation credits by the Trust therefore has the effect of increasing the Net Tangible Assets (NTA), which then influences the return of the Trust and the subsequent payment of any performance fee. The reason the Trust follows this methodology of 'grossing up' any dividend received by the amount of any imputation credits attached, is to achieve a 'before tax' value of dividend income (shown above as \$1,000). Using this 'before tax' value of the dividend income, allows for the consistent treatment and recognition of dividend income with other forms of income that are also earned on a 'before tax' basis, such as interest received at the bank or rental payments received on a property. However, this approach is not the normal practice followed by the industry, but it is one in which I believe most accurately tracks the true return of your investment in the Trust, while allowing for the highest level of consistency and equity. Therefore it is this methodology which I will continue to adopt.

This year has also seen some development in the administration of the Trust. Following Libby and my return to Brisbane from Sydney, the Trust has been able to take the step of moving from a home based operation to renting a modest single person office in South Brisbane. Included with this letter are my new contact details where you can reach me at this new address.

Luke Trickett  
Blue Stamp Company Pty Ltd

## **A Description of the Current Economic Climate**

**‘If something cannot go on forever, it will stop’ – Herbert Stein**

**... And nothing can go on forever**

A lot can be gained from the above quote in understanding how some of the major economies reached the financial instability that they are in. While quite a simple and obvious message, it is often completely lost or forgotten by society and in particular the financial markets. By not recognising the transient nature to all things I believe some very sub-par decisions have been made and continue to be made which I will describe below.

There seem to be many different and varying accounts as to the strength of the domestic and global economy. I view the current macroeconomic situation with a great deal of caution, but the fundamentals and attractiveness of specific businesses with a whole lot of enthusiasm.

### **The Not-so-United States**

Looking at the global economy, I find it hard to be inspired, particularly with the decision making of the major authorities. None of the major drivers of global growth, being the US, Europe and China have a clear road ahead. Firstly in the US, with the Federal Reserve having forcibly pumped trillions of stimulatory dollars into their economy whilst keeping interest rates at historically low levels, only to see their economy stagger and start does not imbue confidence. The US seems to be suffering a severe case of a GFC hangover. Key aspects of this situation is that their unemployment rate remains stubbornly high and this macro factor is inextricably linked to the fortunes of the residential housing market which in turn is critical to consumer confidence, and with this confidence driving consumer spending (which accounts for around two thirds of their economy), the fuel to stoke their economic fire seems absent. Considering the unprecedented levels of stimulation given to their economy for over two years now and to have it still ‘stuck in the mud’, provides a dreary outlook for the world’s largest economy.

The most asinine thing amongst all of this is the major political parties in the US willingness to play brinkmanship with their own weak economy. That the political leaders would use the fragile situation of their finances and the urgent need to increase their borrowing limit (so they may continue to pay their bills on time), to pursue their own political agenda is bewildering and disappointing but yet not that surprising given society’s propensity toward short-termism, not to mention the degree to which politicians suffer from this affliction. Recognising the requirement to access more borrowings so late has led to hasty negotiations being made between a divided government and as a result, a compromise has had to be agreed to that seems to suit no one. The US government has been forced to reduce its spending to relieve the pressure on its finances, however this same action removes a vital source of stimulatory spending to the weak US economy and places it at risk of further decline. On a different front, with so much cash having been injected into this economy and with interest rates having been kept (and remaining) so low for so long, inflation may begin to rear its head. The potential of inflation (while it may sound a little contradictory to have inflation in a sluggish economy), may be further raised if another round of quantitative easing (the Federal Reserve directly injecting cash into the economy) is embarked on and at the same time the government decides that a great way to pay their debt would be to print money! If inflation were to emerge in the US, with such a slow rate of economic growth and high rate of unemployment, the situation would become even more complicated. These conditions of high inflation combined with low economic activity create stagflation, where the trade-off is the lesser of two evils, which is to either raise interest rates to control inflation, while at the same time running the risk of further

damaging the economy or the second option, to try to stimulate the economy through low interest rates but potentially inciting inflation further. Interesting times...

### Europe

Moving to Europe and the root cause of their situation is exactly the same... the overuse of debt. Debt seems to be the common thread that unravels human's economic situation, both on a household level, corporate level and governmental level. During the 'good times' when an economy might be prosperous, the money flows freely and finds its way meandering down into each individual business including all its stakeholders (e.g. employees, customers, shareholders etc.), and through this mechanism it then filters down into each household. By not acknowledging how fleeting these 'good' times can be, households, businesses and governments can over commit themselves, thinking that the prosperity will endure and that the pain of low levels of economic activity was a thing of the past. Unfortunately it is the presence of debt that endures long after the boom has ended.

There are a number of European economies which are experiencing the effects of low levels of economic activity with this stress being amplified by high levels of indebtedness. These European economies have been able to borrow too much for too long and at interest rates that do not reflect their ability to service the debt. These European nations are stuck in the position where they need to either increase revenues (i.e. taxes) or reduce their spending so they can service their debt. Because they are finding it hard to increase their revenues and simply have their economies trade their way out of their position (higher economic activity brings with it greater revenues for the government through more taxes), they are forced with the alternative of reducing spending, increasing taxes and asset sales. These austerity measures generally, either directly or indirectly, come in the form of sacking workers, reducing their pay and increasing the cost of living. This then compounds the effects of the recession that each individual citizen and their family feel and perversely reduces economic activity further, leading to lower revenues. What a mess...

### Europe's Crisis – Look Familiar?

The European situation is being caused by slow growing economies that have been overloaded with debt. Some of these countries include Greece, Portugal, Ireland, Spain and Italy. The debt which these countries have borrowed for so many years is held by many different institutions and when it looked increasingly likely that some of these countries will not be able to meet their repayments, the governing bodies being the International Monetary Fund, European Central Bank and European Financial Stability Fund among others formed a set of rescue packages to try to avoid a default and potentially another GFC.

Showing the Greek situation by way of an allegory reveals how similar its situation is to another country's. In this example, let's give Greece the name of Gary and we will call all the institutions that have lent to Greece, banks. Now, Gary was currently employed and earning a modest income. Seeing all his friends buying houses and selling them for substantial profits, he decided to do the same. As it was 2006 at the time, the standards to getting a loan from the banks were pretty low because they were all fighting over who could lend the most. On top of this, because the interest rates were quite low too, the banks lent him an amount which was far greater than what his income could support. However no one expected at the time that the economy might slow down, property prices might fall, that Gary might lose his job and that his income would dry up. So when Gary lost his job and interest rates went up and it looked all too likely that Gary would default on his loan, in came his parents (who had a good credit standing) to try to talk to the banks and avoid a default. His parents decided that to achieve this, they must essentially takeover Gary's debt to the bank, and have him repay them instead. While this has helped solve the problem on the surface, all it has done

is let the banks off the hook and passed the investment risk and consequences of poor lending practice to the parents. Describing the Greek situation like this shows that it is a lot like what happened in the US with the sub-prime crisis. Effectively what is happening in some European countries is the same thing on a much larger scale. Instead of individual home owners over committing themselves and defaulting, it is whole countries defaulting on their indebtedness. However, with the governing authorities coming in and bailing countries out, the economic reality of the original lending has not been fully reflected. While the banks have escaped, the debt has not disappeared but has merely been passed up the organisational hierarchy. This process of escalating the debt to higher authorities, while may provide temporary stability and smooth over the underlying situation, in the long term it has ramifications which could be more far reaching. What started off as a global financial crisis concerning the viability of large financial institutions appears to be slowly morphing into a global financial crisis concerning public institutions. A global sovereign crisis.

In reality it is the German and French taxpayers that are acting like Gary's parents. How long these tax payers are going to remain obliging to Greece and other unstable European economies remains a question. I suspect, not as long as that of a parent, particularly when aiding these weak economies forces their own financial obligations up. The German and French governments may find themselves in politically hostile environments if public support for this assistance diminishes.

Simply because the issue might disappear from the newspaper headlines, do not be lulled into thinking everything has now corrected itself. The media and markets tend to suffer an acute form of myopia and forget about issues if they are not currently in focus, but the debt will continue to remain until some tough decisions are made.

### Europe's Crisis - The Structure

Some of the origins to this current predicament can be found in only pursuing monetary consolidation amongst the Euro zone states without any other form of unification (with monetary policy being broadly described as the policy set by an independent central bank, such as our RBA, to moderate or stoke economic growth whilst trying to ensure a low and steady rate of inflation and low levels of unemployment). That is, by consolidating the Euro zone under the one monetary framework, a one size fits all approach was taken to a broad spectrum of economies.

Comparing this structure to Australia we can see how far monetary union on its own falls short. Australia has monetary union between all the States and Territories. This means that we can use the same currency in Queensland as we do in New South Wales and the interest rate set by the Reserve Bank of Australia applies equally to those in Western Australia as it does to those in Victoria. This works well because the Federal Government, which we all elect, implements policies and laws and provides services and support, which apply to all States and Territories and therefore creates consistency in the economic conditions that each experiences. This means that the monetary policy which is enforced across all of these States and Territories is more or less appropriate for the economic climate that each State or Territory is experiencing. This structure where the political, fiscal (think government financial policy) and monetary policies all apply to the same population is essential to the success of each policy and to that of the whole.

Reconciling this situation to Europe we can see that monetary union is applied across the Euro region however each individual country has its own political structure, where the political and fiscal agenda does not necessarily complement the monetary agenda. This disconnect between the area the monetary policy is influencing as to the area the political and fiscal policies are affecting can create significant imbalances. These imbalances have arisen because the monetary policy that is applied

across the Euro region as a whole is equally applying to those economies that are financially responsible and growing, as it does to those that have not been well managed, are uncompetitive, unresponsiveness and have a vastly different culture. As a result of the accumulation of years of these imbalances, a wider and wider divergence between the monetary policy that is actually required for an individual economy to what is prevailing has occurred. It is this realisation and adjustment by the market which we are now seeing. Similar to many other financial phenomena where distortions seem to have a circular pattern of reinforcing themselves, the imbalances caused by this structure further drive more imbalances. This is a structural weakness to the current European situation.

### *Europe's Crisis – The Monetary Union Strait Jacket*

The same framework that contributed to Europe's current situation is also making it more difficult for the weaker countries to turn their economies around. By sharing a common currency with the financially strong Germany, the sluggish Italian and Greek economies do not have the very valuable feature of being able to let their exchange rate fall, allowing their country's exports to become more competitive and helping to stimulate their economy. Unfortunately, under the single currency structure, Greece and Italy are effectively shackled to the strong Euro and in the meantime this strong currency is slowly crushing their economies.

One thing is for certain, for this situation to be resolved there will have to be change. The current mindset of delaying the inevitable cannot endure. If the debt has not been managed in some way, it will continue to be a drag on economies. Perhaps the Euro region may be forced to dismantle, allowing each country to operate with the flexibility required for its own financial situation? Or they could even look to what the Queensland lender, Suncorp did at the onset of the GFC and facing enormous lending losses, which was to split their operations into a 'good bank' and a 'bad bank', so as they could isolate the poor lending and then focus on selling it or winding it down. This allowed the good bank to act freely of the other. By allowing the economically weak Euro region countries to leave temporarily and form their own 'bad euro', might give them the freedom to turn themselves around. Moving the other way, the European leaders might even decide to integrate the weak Euro countries further, where the Euro region could take the next steps toward unification, being fiscal union and then political union.

### *Europe – Facing the Reality*

However the reality is that as long as the debt is not paid down or reduced (by way of a default) it will not disappear and these economies will continue to be weighed down, corroding the growth and vibrancy in the long term. It also puts at risk those authorities that have taken on the financial burden required to pass the debt from the investors to the government bodies. While this escalation of debt looks better in the immediate term, it actually exposes the sovereign bodies to a greater level of risk over the long term (this is a contributing factor to the US government's current level of borrowings). A result of passing the debt hot potato is that the reality of the original investment has not been reflected and the debt remains. The two options seem to be either to make the tough decisions now, feel medium term pain and see long term gain or short term gain but long term pain. It seems as though the latter will be followed. By allowing a controlled default of any country that cannot sustain their borrowing levels, the authorities, while being faced with medium term dislocation, would be allowing these economies to prosper in the long term. In accepting that Greece cannot realistically face its mountain of debt, and that the current situation cannot go on forever, reality would be able to shine through and a real solution that provides long term benefit achieved. If Greece cannot continue on as a viable debtor with a growing economy, why continue to window dress? By allowing the true economic picture to be realised, Greece's debt would be reduced, at the expense of those that lent the money to Greece, and then Greece would be able to go

about reforming their economy and allowing it to grow again. The creditors would realise that if they make poor investment decisions, they will have to face those decisions. Perhaps the creditors investment decisions in the future will be improved by this (and in turn, reduce the risk of a future crisis). The authorities could then go about ensuring the citizens of Greece were protected, rather than the financial institutions. Expressed another way, if a volcano was about to explode and this was inevitable, wouldn't it be best to ready all those citizens that would be in the path of it and remove them from the danger before it happened, rather than simply trying to fill it in and do some other superficial work in the hope of delaying when it did explode?

### *China – Australia's Fuel for Growth*

Finally moving our attention closer to home brings into light the growth driver of our own economy, China. While China continues to charge ahead, growing at a good clip, with this growth being fueled by the development and urbanisation of their massive population, there are a number of significant uncertainties. First of all, while a tremendous economy they are, a free, democratic and liberated country they are not. With so much growth occurring, asset prices (such as housing) and commodity prices (such as food) also inflate. There is a risk that inflation (increases in the price of goods and services) may rise significantly faster than wages, making it more expensive for consumers to continue to live. As China experiences these growing pains that come with capitalism they do not have the free and democratic political environment which normally accompanies economies of this size and nature. The absence of this democratic system removes the pressure valve which citizens usually rely on when they are dissatisfied at how things have been handled. Instead the citizens of China are left with the overbearing force and unresponsiveness of a concentrated, entrenched government. This has the potential to lead to riots and other displays of unrest as citizens try to make their voices heard. This environment does not bode well for smooth and steady economic growth. A further effect of this political landscape is that accountability and transparency are not defining characteristics. With these two aspects missing, the long term reliability of China is put in doubt. This lack of transparency is shown when credit ratings agencies uncover an additional 3.5 trillion yuan (\$490 billion) in loans to local governments as compared to what the Chinese National Audit Office reported. Simple things like this misunderstanding of how much debt is really out there indicate that maybe not everyone that should be aware of what is going on, is actually aware. Also when there is a lack of accountability coupled with boom time economics, large scale spending towards projects which make little economic or common sense proliferate. Add to this the low standards and corruption that occurs in this environment and it does not provide the seeds for sound long term development of a country's physical infrastructure, social atmosphere or economic growth, no matter what the current environment is like.

### *Home*

Moving home and our economy seems to be experiencing conflicting conditions, from the high demand for our natural resources to the tough operating environment many retailers are finding themselves in. Australia is very fortunate being located on China's doorstep whilst at the same time having an abundance of the natural resources required to fuel the expansion of the world's most populated country. However our growth is intimately tied to the prospects of China and while we may no longer be riding on the sheep's back, Australia is certainly riding on China's back.

While China is growing strongly at the moment, just like any other country, it too can be susceptible to the same vagaries of greed, growth and excess that has fueled nearly every other major crisis. It is in this very time of expansion and seemingly unending growth that the passing nature of these boom times are not appreciated and the seeds for future financial crises are sown. Perhaps early symptoms of this have already started bubbling to the surface, with China's annual inflation rate running at 6.4% and their residential property market experiencing such spectacular



risers that in some parts, commentary of bubble like conditions are emerging. Reconciling these conditions with the fact that a lot of the development has been achieved through loans to local governments to fund large scale and sometimes unnecessary infrastructure, causing land prices to increase more than otherwise, one can see all it needs is a slowing in China's economy and a fall in property prices (as happened in the US), and a large amount of these loans could turn sour very quickly. Australia would surely feel the effects of this.

### *A Second Financial Crisis?*

A real danger lies in the possibility that if major European economies such as Italy and Spain require financial assistance, the problem will become too large for the authorities to manage. Add to this, the major banks around the world that have a large exposure to this deteriorating government debt, and these banks, the pillars to the financial system again look shaky. On top of this, many government and regulatory bodies just aren't in the financial position to offer the support they showed in 2008 as all their bullets were used in this first crisis. Now they are faced with the situation where they cannot borrow more to stimulate their economies, they cannot reduce interest rates as they are already at very low levels and unemployment is already high. Also, while the stimulatory policies followed by China in 2008 were a major source of growth for the world, now however China does not have the same flexibility. China is in a very different economic landscape now than in 2008, where providing the same economic stimulus today in the face of another global downturn could destabilise all of the measures they are currently putting in place to moderate their economy.

Reading this and one could be forgiven for thinking that things are looking very ordinary, and while that might not be far from the mark, there is a key difference today as compared to 2008 and that is the level of indebtedness of households and private institutions. Following the GFC, many institutions were forced into reducing their level of borrowings, and now are in a much stronger financial footing. This is significant as it is these households and private companies that are the real engine to any economy.

As witnessed by the recent events on the world financial markets, this period ahead may be characterised by high levels of uncertainty and volatility. But when the dark clouds of a crisis have gathered on the horizon and the markets are gripped in the mentality of the mob, and it looks all too likely the world is going up in smoke, it is in this very moment that we must stand up in the face of that panic, look it in the eye and not waver in our conclusions, but continue on with resolve and equanimity so we may think and act with the freedom of solitude. We must have the foresight to see through these times, to know that they cannot last forever. Just as we know in the heady days that they too cannot endure. This approach will see us through this environment and allow us to exploit the folly of others so that time may reveal the fruits of our fortitude. If this sounds like a call to arms, you're probably right. This is an extraordinary period for world finance and one in which anything may happen.

Seeing the stock market for what it is (an enormous market selling all different kinds of companies, with constantly changing price tags) allows us to see the irrationality of some of the decisions and then take the opposite action to the masses if need be. So being alert and open we will be able to find our way through this period and grow from it.

### Summary

During challenging times, it seems as though the perverse effects of debt become self-fulfilling. That is, when a business's products or services become less demanded in times of slow economic growth, the proportion of income required to meet interest payments on debt becomes more and more. If the decline in activity continues, the debt does not diminish also, but perversely, the debt burden grows bigger and bigger, causing a vicious spiral of ad-hoc measures aimed at ensuring survival. The goal of the business has now moved a long way from where any sound company's attention should be, which is above average profitable growth. However, now being forced into these survival measures the business generally is forced into making cost cutting decisions, such as having to reduce the number of workers or jettison operating divisions. However this can cut into the muscle and compromise the income generating capacity of the company. Another option to tackle the debt burden is to sell non-core assets, however the business is now being forced to sell assets at a time when they would probably fetch some of their lowest prices. This is the perverse, self-fulfilling loop businesses with heavy debt burdens can find themselves in. On this point, it is not just businesses and households that can find themselves in this cycle, as widely publicised it is this same cycle that many European economies are in and it seems this is what the US has agreed to in negotiating an increase to their debt ceiling.

How did it get to this? Well simplistically, it was not appreciated, when times were good in the latter part of the last century and early years of this new century, that this cannot continue forever, and so not only was no action taken by some countries to reduce their level of indebtedness but the opposite approach was taken of increasing their borrowings. Unfortunately the presence of these borrowings has far outlasted the business cycles in which they may have been originated in. With Europe and the US shackled by debt that doesn't look like it will be able to be moved for decades and Japan, an already debt laden country having been shaken by natural disasters, the outlook does not look rosy.

Even with all of this in mind, I am still incredibly bullish on equities. Why? Even if the US, Europe and Japan default and China makes a mess of their economy, there will still be 6.9 billion odd people living on the planet who still need to consume goods and services in order to go about their daily lives, and for now, capitalism still remains the best mechanism to facilitate the exchange of those goods and services. So in turn, private enterprise – of which is an integral cog to the economy and to the structure of capitalism – will remain relevant. Identifying companies which are well managed, that have products relevant to society's needs (and these products aren't easily replicated), have a good relationship with their customers and suppliers and have been financed on a sound footing so they won't be caught in a debt spiral, will always perform well over the long term no matter what is going on in the globe. It is the identification of these companies which is our goal and having the ability to act in these uncertain times is one of the greatest assets we have.

Luke Trickett  
Blue Stamp Company Pty Ltd

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