Dear Unitholders,

The Fund generated a good return during the year as you can see in the following table, which compares the Fund's return (net of fees) to the Australian All Ords Index and the MSCI World Index.

To 30 June 2017	STAR	All Ords	MSCI ($A)
1 year	17.3%	13.1%	15.3%
3 years (%p.a.)	28.1%	6.8%	12.2%
5 years (%p.a.)	26.7%	11.6%	17.2%
7 years (%p.a.)	26.6%	8.8%	12.2%
10 years (%p.a.)	15.6%	3.5%	5.0%
Since inception on 1 Nov 2003 (%p.a.)	14.9%	8.7%	7.1%

A variety of companies contributed to the Fund's good performance. These included:

- Emeco bonds (adjusting for recapitalisation) - up 102%
- South32 – up 78%
- Goldman Sachs – up 51%
- Kangaroo Island Plantation Timbers - up 40%
- Spicers ordinary and preference shares (blended) – up 37%
- United Overseas Australia – up 34%
- AIMS Property Securities Fund – up 25%

Our biggest losers (again!) were various call and put options on the S&P 500 Index, which reduced the Fund's performance for the year by 1.4%. We will discuss this later in this letter.

The Fund had an average cash weighting of 26% during the year, which was a drag on its performance relative to strong share markets in Australia and elsewhere.

Kangaroo Island Plantation Timbers Ltd (KPT) www.kipt.com.au

KPT made good progress during the year, in particular purchasing the other large timber estate on the island for $55m. This purchase makes it probable that KPT will be able to turn its substantial land and timber assets into a source of sustainable revenue and profits.

The key unknowns with KPT are how long it will take to commence production and how its timber will be exported. KPT has applied to develop a wharf on its land at Smith Bay. If this application is approved, which we believe is likely[1], then KPT shares have considerable upside.

If KPT's wharf application is rejected, then KPT does have other potential routes to market, one of which it has consent to access.

Even though our KPT holding was already well above our 10% maximum weighting, we subscribed for more KPT shares to help complete the timberland purchase. This made KPT shares more valuable and KPT a more secure business than if the purchase had not gone ahead.

[1] The reason we regard approval of the wharf as likely is that the wharf will provide considerable benefit to both Kangaroo Island and to the state of South Australia. These benefits include the creation of over 118 full-time jobs, a new export industry and improved access to markets for other industries on the island. The proposed wharf will also benefit the island's tourism industry. A key attraction for the SA government is that KPT is asking for no government subsidies for its project.

It may seem paradoxical, but we believe that taking up more KPT shares to complete the purchase reduced the KPT downside risk in our fund even though it increased our weighting in KPT.

Despite that, we are acutely aware that our 35% weighting in KPT is well above our preferred maximum weighting in any company of 10%. It remains our intention to reduce this holding, but as we are optimistic about the company's prospects, we feel no urgency to reduce it at this time. This is a matter that we have discussed at length many times internally and are continuing to monitor.

Macroeconomic views

We have generally been cautious in recent years, believing that most world equity markets are in the second half of a major bull market that started in early 2009.

The equities bull market, like the GFC that preceded it, is largely a product of conditions in the global credit market. Central banks around the world have flooded markets with easy money at low interest rates in order to stimulate economies. This has been only moderately successful in the real world of production and employment, but has generated spectacular growth in asset prices, especially bonds and related asset classes like property and equities.

It's easy to find examples of over-exuberance in the credit markets. A recent example was a bond issue by Tajikistan, a small country adjoining China and Afghanistan. Tajikistan's per capita income is $US 804, its politics are unstable and corrupt, and its major source of export revenue is from drug trafficking. A 7.1% interest rate *(if all goes well)* for ten years is poor compensation for these risks. It's not just Tajikistan. Ukraine, a troubled country at war with Russia, and Argentina, with a long track record of defaulting on its foreign debts have both recently issued long-term bonds with interest rates of around 7%. Some of the buying of this third-world debt has been done with borrowed money, meaning that if prices fall, those holders become forced sellers. Some buying has been through funds that offer immediate liquidity, but in a difficult market third-world bonds could become very illiquid. This is an accident waiting to happen and it will lead to interesting aftershocks.

At the other end of the credit spectrum, German ten-year bonds yield 0.41%, despite European inflation running at 1.76%. Anyone buying German bonds at that yield is almost assured of losing money in real terms.

With remarkably low interest rates, it's no surprise that global equities have been strong. The world equities index rose 19% in $US terms during the year to 30 June 2017, and is up a further 7% since that time. While global equities are, in general, far from cheap, we see surprisingly few examples of speculative excess in equities markets, relative to the obvious excess in much of the credit markets. The only real bubble we can see is in Bitcoin and other cryptocurrencies.

The one asset class we regard as attractive is option volatility. This is partly because of the linkage between credit markets and volatility[2], and partly because global markets for both equities and credit have been unusually stable for much of 2016 and 2017.

We have responded to this by buying a mixture of call and put options as a bet on increased volatility and we have also bought some highly risky call options on the S&P 500 Index as a bet on the US bull market accelerating. Our objective is to make a lot of money if the US market goes up a lot more, but not lose much if it falls. The attached note explains what we have been doing in more detail.

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[2] Many investors have been persuaded by their friendly stockbroker to generate extra "income" by selling call options over shares they own. The sales pitch is that the share price goes up, you still sell at a profit and if the share price goes down, you keep the extra income. With increased demand for income, such selling has helped to push down option prices.

Despite our expectation that markets would become more risky, they have remained stubbornly stable, costing us a total of 1.4% of our Fund during the year.

Although we have been saying this for a while (and been wrong so far!) we still believe that global bond yields are unsustainable and will eventually rise, possibly sharply. *When* this occurs, we expect to see some turmoil in markets, and opportunities for the Fund to invest on attractive terms. Rising global interest rates would be particularly damaging for Australia's economy and property markets, where debt and complacency are high.

This is part of the reason we hold so much cash. About 15% of the Fund is in cash at the time of writing. In future difficult market conditions, cash will give us opportunities to invest on very attractive terms, while exposing us to no risk while we wait. For this reason, we think of cash as a risk-free asset with large potential upside.

Our attitude to risk is summarised in the following paragraph, which has appeared in previous annual letters.

Because we do not have the ability to accurately predict economic and market conditions, we aim to diversify in a way that can be expected to do reasonably well across the widest possible number of potential scenarios. This requires that our strategy is able to overcome not only occasional bear markets and dislocations, but all of the other hurdles that are endemic to active investment management. The list includes bad luck, bad timing, and occasional mistakes in judgment. Most importantly, any truly robust long-term investing strategy must be built to survive the worst possible scenarios the market can throw at us and allow us to live to play another day. If we do this, we are unlikely to be the best performers in any given year, but we do have a good chance of continuing to generate satisfactory overall returns.

The Fund's robustness is assisted by our longstanding policy of having a high proportion of the Fund in cash, or in securities which themselves have net cash on the issuer's balance sheet. During the year, an average of 26% of the Fund was in cash and at year-end, 15% of the Fund was in cash. In addition, at year-end, 37% of the Fund was in companies which themselves had net cash. As we both have large personal stakes in the Fund, this policy helps us to sleep soundly.

Outlook for the Fund

The current financial year has started well, with the Fund up over 7% so far. While we remain optimistic about the Fund's long-term outlook, we warn you to expect lower returns in the future. Although we are finding it harder to find new attractive investments, there are several positions we are close to buying.

Yours sincerely,

Fred Woollard and Nigel Burgess

31 October 2017

https://twitter.com/FredWoollard

S&P 500 options trades and buying low-risk exposure to Trump's bull market

What have we been doing with your money?

We have invested 2% of the Fund in each of two separate, but related bets on the S&P 500 Index. One is a bet that US implied volatility is too low. The other is a bet that the US market continues to rise, but done in a way that ensures we won't lose much if we are wrong.

The first bet consists of buying call and put options on the index with the same strike prices and maturities. For example, we own both call and put options exercisable at 2470 until 15 September. The combined cost of these options in July was 60 points, meaning that to make a profit on this trade, the index needs to either fall below 2410 or rise above 2530.

What is our rationale for buying call and put options?

Implied volatility[1] is now trading at record lows across a variety of asset classes, especially in US equities. This means that option markets are priced in the belief that the economic and political outlook in America and the world is as stable as it has been for more than 25 years.

We believe the recent period of global financial stability will end, possibly quite dramatically. Reasons for this belief include:

1. There is much that could go wrong in global politics, especially when the US is led by Trump.
2. The world, especially China has a lot of debt. We don't understand China well enough to know if its financial system is highly vulnerable as some people argue, but we regard this risk as very real. High debt levels make individuals and the financial system more vulnerable to shocks, including higher interest rates which are inevitable (but probably not soon).
3. Buying options has, in general, been a poor strategy in the last couple of years, as we know from direct experience! Conversely, selling options has generally been very profitable over that time. In the USA, there are funds that specialise in different option selling strategies. These funds have generated very good returns and are attracting significant new money. We recently observed the creation of a retail fund whose strategy is to sell put options. This flow of new money has pushed option prices down further as those funds are forced to sell the options that they were established to sell. If markets become more volatile, those funds will rapidly lose a lot of money and some might be forced to cover their positions as investors respond to large losses by withdrawing their remaining capital.
4. Some investors have also been attracted to selling options as a way to generate "income" in an environment where it is difficult to find safe ways to generate high income. In general, taking added risk to boost one's income is a dangerous strategy. It adds to our enthusiasm for option buying to know that much option selling is, in effect, being done by ill-informed retail investors chasing income and hot recent returns.
5. A high proportion of US equity market ownership and trading involves investors with very short-term time horizons and various forms of leverage. These factors add to instability when markets become unstable.
6. The key point is that option bets are a gamble with attractive odds. If future volatility is similar to historic volatility, then our September options position has an expected value about 180% of the price we paid. If future volatility is in line with the recent actual low volatility, then the expected value of the bet is about 80% of what we paid. Although options

[1] Implied volatility is the measure of the market's expected range of share prices in the future, which is stated in percentage terms. It can be calculated from the price of an option.

have inherent obvious risk, this combination of the bet having an expected value of 180% if we're right and 80% if we're wrong is very attractive.

<u>How to participate in the great bull market (but take little risk)</u>

Despite our many worries about the world, we think it quite probable that the S&P Index has not yet reached a peak. Indeed, we think there's a good chance that the US market could accelerate its rise. The main reasons for this opinion are as follow:

1. Most importantly, the US is enjoying one of its great historic bull markets. Since it bottomed in March 2009, the index has risen 270%. There remains much scepticism about US stock prices, especially from old-fashioned value investors (like us!). The history of big bull markets is that they often go on long after the old-timers say they've gone too far, and often end up rising at a fast rate as an increasing share of the population gets dragged into the bull market. With global interest rates remaining low and likely to stay that way for a bit longer, the chance of an accelerating, or even parabolic rise in the US market is quite high.
2. Donald Trump is unashamedly pro-business. His stated policies include cutting taxes for rich people and corporations, allowing businesses much greater freedom to pollute, giving banks greater freedom and reducing protection for workers and consumers. These policies, if enacted, are great news for US investors, at least in the short term.
3. Several members of the US Federal Reserve board are due to retire next year, including its Chairman, Janet Yellen. As a property investor with large debts, it is in Trump's interest to ensure that the Fed is led by governors who will keep US interest rates low and US monetary policy easy. If the Fed explicitly announced that it intends to do this for the next few years, asset markets would be likely to respond very favourably.

We've invested 2% of our fund in call options on the S&P Index that only have value if the index rises 10-15% over the next year. One option we own expires in June 2018 and is exercisable at 2800, 13% above the market's current level. We recently paid 5 points for this option, or 8.6% implied volatility, which is close to a record low. Based on historic volatility levels, when we bought the options, there was a 30% chance that the index would rise over 13% over that time, and if that happens then we could expect to make over 30 times our money. That is to say, the option has an expected value of about ten times what we paid for it, *based on historic volatility levels*.

On the other hand, if current levels of volatility continue, then this option has only a 7% chance of having any value and we've made a bad investment.

<u>No, we haven't lost our usual risk aversion</u>

We recognise that you may be surprised to learn that we are investing in assets which have a high probability of being worthless. Before you become too worried, we point out the following:

1. We are only investing a few percent of the fund in options. Even if all of these go to zero, the loss to the fund will not be serious.
2. We still have over 15% of the fund in cash and another 8% in assets that are very similar to cash.
3. Most of our remaining assets have a low correlation to the index and are fairly safe. In particular, our 30% stake in Kangaroo Island Plantation Timbers represents a semi-control position in a solid real asset.
4. Our portfolio mix is intended to match or exceed world indexes if markets go up a lot, while still generating a reasonable return if markets are flat or go down. We believe this is a good

approach to the second half of a bull market, where most assets are expensive or fairly priced, but options are extraordinarily cheap by historic standards.

Unitholders are welcome to call me to discuss.

Fred Woollard

10th August 2017

https://twitter.com/FredWoollard

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If you are thinking of buying options, we remind you that there is a high probability that you will lose most or all of your investment. Options are an unsuitable investment for most investors.