Dear Unitholders,

The Fund generated a satisfactory 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 2018	STAR	All Ords	MSCI ($A)
1 year	35.4%	13.7%	15.3%
3 years (%p.a.)	29.0%	9.5%	9.7%
5 years (%p.a.)	30.1%	10.3%	14.2%
7 years (%p.a.)	26.0%	9.0%	14.0%
10 years (%p.a.)	22.0%	6.2%	9.0%
Since inception on 1 Nov 2003 (%p.a.)	16.2%	9.0%	7.6%

The main contributor to the Fund's performance was our call options on the S&P 500 Index. Without them, we estimate that the Fund's return would have only been around 7-8%.

There were three principle reasons why the Fund would have underperformed so badly in the absence of the options trades. The first was that we held 27% of the Fund in cash, which yields less than 2%. The second was that we held over 20% of the Fund in Kangaroo Island Plantation Timbers, which rose 6% during the year. We will discuss both of those later in this report. Finally, as always, some of our investments performed poorly. Two of the worst were Blue Sky Alternative Investments[1] and OneMarket, which fell 19% and 18% respectively from the time of purchase until year end.

Some of our companies did well during the year. These included:

- Emeco - up 169%
- An Australian gold producer, which we sold and might buy again – up 127%
- South32 – up 35%
- Spicers – up 32%
- Salmat – up 31%
- Vealls – up 27%

We've been gambling with your money.

As option trading has made such a large contribution to our returns, it seems a good time to discuss our approach to risk, especially as it influences our option trades. Like all fund managers, we take risks with our clients' money, and believe it is important that you understand how we think about it.

Investment risk is remarkably complex[2]. We don't pretend to be experts in it, but have developed several "rules of thumb" that we use to try to avoid serious losses while still generating good returns.

The first is to find investments where there is little or no chance of loss, but significant uncertainty about the possible upside. These are our favourite kind of "gambles", which we think of as being analogous to a coin toss conducted of the basis of "heads I win, tails I don't lose". Ideally, we'd have a portfolio containing a diverse mix of these kinds of bets, but in the real world they are hard to find, especially in today's heated markets.

[1] We subsequently sold out of Blue Sky, suffering a total loss of 12% of our investment.
[2] If you wish to learn more about this subject from a master investor, we recommend reading "*The Most Important Thing*" by Howard Marks.

Past examples of these include Acrux, Emeco bonds, Macquarie Atlas Roads, Infigen, Microsoft or South32 when these securities were purchased.

The second type of gamble we like is one where there is a significant chance we could lose part or all of our money, but we believe the odds are substantially in our favour. The simplest example of this is to imagine you were offered ten to one on the toss of a coin. Even though there is a 50% likelihood that you would lose your money on any individual toss, this is a very attractive bet *provided you understand the odds and limit the size of your bet to an appropriate level*.

Examples of this type of gamble are our recent purchase of OneMarket or our options trades looked at individually. Our typical “bet” size is 1-2% of the Fund, although we bet over 5% on OneMarket.

An alternative approach to gambling is to imagine a poker machine[3] that has been programmed to pay out more than 100%, compared to the usual 80-90% in the real world. Like a real-world poker machine, our imaginary poker machine would most commonly take your money, but regularly give you a small payout to keep you keen and occasionally pay a big win. The key difference, of course, between our imaginary poker machine and a real world poker machine is that if you spend a lot of time at a real world poker machine, then it is very likely to cause you significant losses, whereas regular visits to our imaginary poker machine are likely to result in large profits.

Sustained periods of benign market conditions and low realised volatility sometime result in low levels of “forecast volatility” and cheap financial option contracts. These are the periods when we tend to buy options. We have had several years of buying statistically cheap options and have had an experience similar to that of our imaginary poker machine. We have had periods where we just keep pouring money into the machine with little to show for it, and we’ve had the occasional periods of large gain. Overall, the experience has been highly profitable.

The options trades have provided unexpected benefits. One is that while call options are individually highly risky, if combined with cash and defensive securities (i.e. what we have mostly owned in recent years) you can create a portfolio that has the characteristics of a “heads, I win a lot, tails, I don’t lose much” type of gamble. That is to say, if world markets are declining, such a portfolio won’t go down as much, but if markets are rising, especially if they are rising fast, it can rise faster than the market. There are, of course, no free lunches in markets. The downside of the “cash + options” approach is that when markets are flat, you are likely to underperform slightly.

The best part about having a portfolio with the above characteristics means that an investor (especially a fund manager) is under much less pressure to buy shares when prices are high and markets are booming. Bull markets create strong social and business pressures on fund managers to participate, which some people call Fear of Missing Out, or FOMO. We have experienced FOMO in previous bull markets and seen its ugly aftermath both on ourselves and others. Using call options to inoculate oneself against the siren call of a bull market helps us to retain cash to scoop up bargains when bull markets inevitably end.

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

[3] Our American readers might know these as “slot machines”.

unlikely to be the best performers in any given year, but we do have a good chance of continuing to generate satisfactory overall returns.

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

KPT remains our largest holding, comprising 21% of the Fund at year end. Progress toward wharf approval, which is necessary to unlock KPT's value, has taken longer and cost more than we or the market had expected.

A 2,500 page Environmental Impact Statement about KPT's proposed wharf was recently lodged with the South Australian government. This is a key step in the approvals process, and we expect a decision some time in 2019.

If the wharf application is approved, which we believe is likely[4], then KPT shares have considerable upside. If it is rejected, then KPT does have other potential routes to market.

Despite the delay, we retain confidence in KPT's management and believe that KPT will eventually turn its land and timber assets into a source of sustainable revenue and profits. We like the long term outlook for woodchip prices and, while we wait, KPT's trees continue to grow at about 5% pa.

Macroeconomic views

We have generally been cautious in recent years, believing that most world equity markets are or, until recently were, in the second half of a major bull market that started in early 2009. Australian and global equity markets are currently down from their recent highs. We don't know if this is the end of the bull market, but either way it doesn't much affect how we run our fund. Bonds and equities remain expensive and until we find sufficient attractive investments, we will remain cautious.

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 property and equities. Donald Trump's decision to massively increase the US government deficit at a time when the US economy was already very strong is good for the US economy in the short run, but adds to our longer-term worries. When interest rates rise another few points, or the US enters recession, both of which are inevitable, the United States will probably face a difficult situation with its debt and deficits.

Last year, we wrote about excesses in emerging market debt, such as Argentina and noted the very low yields from high-quality governments bonds like Germany. Investors in both classes of government bonds (weak and strong) have generally experienced poor returns since then.

Today, we are particularly worried about the level of corporate borrowing. Corporations, especially private equity funds, are able to borrow not just at abnormally low rates, but lenders are willing to lend higher multiples of profit than has been traditionally regarded as prudent. As if this were not enough, the competition to make loans is so intense that lenders are willing to relax the covenants (i.e. the fine print of loan contracts designed to protect lenders), which will weaken lenders' ability to enforce repayment when economic conditions become difficult, and lead to greater loan losses.

[4] The main 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 250 full-time jobs, a new clean export industry and improved access to markets for other industries on the island. The proposed wharf will also benefit the island's tourism industry.

In addition to easy lending markets, private equity firms are also benefitting from strong inflows into their funds as investors seek out any asset that can plausibly promise high returns. Private equity firms are incentivised to do deals, and with hundreds of billions of funds flowing into the industry globally, private equity firms have been paying unusually high prices to take control of listed companies. This has been an important factor in the recent bull market. We do not expect this to end well for either investors in private equity funds or their lenders.

Despite the modest lift in interest rates already seen in most major countries, 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 consumer debt and complacency remain high.

This is part of the reason we hold so much cash. 22% of the Fund is in cash. 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 cash is our favourite asset class, a risk-free asset with large potential upside.

We have continued 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. At year-end, 25% of the Fund was in cash and 34% 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.

Welcome to Mitch Taylor

In late 2017, Mitch Taylor joined our firm as assistant portfolio manager. He has fitted in well with our team and has added significant value to the Fund, both directly and indirectly.

Closing the Fund to new investors

On 1st January 2018, we closed the Fund to new investors. Our main reason for doing this was to prevent the Fund growing larger or faster than we are able to manage. We remain unsure about our optimal size, but it appears that we can manage more than we do at present, while still generating good returns. We expect to re-open sometime in 2019, but have yet to make a decision on this.

Outlook for the Fund

So far, this financial year, the Fund is up about 1%. This is not a great return, but compares favourably to the Australian market which is down 4% over the same period. We are finding some new investments, which we are buying cautiously.

While we remain optimistic about the Fund's long-term outlook, we warn you to expect lower returns in the future than we have experienced in recent years.

Yours sincerely,

Fred Woollard and Nigel Burgess

31 October 2018

https://twitter.com/FredWoollard