Our Investment Philosophy

“An investment in knowledge pays the best interest.” Benjamin Franklin

GEMCapital
Financial Advice

How do we think about investing?

Some important background

Good investing in our opinion involves having a sound philosophy, good access to information, and the courage to either stick with your strategy when markets are going against you, or to be flexible enough to change your position if new information comes to hand.

We have refined our investment philosophy over many years, and it has stood the test of time over market downturns as well as good times. We have also enhanced our access to information whereby we access some of the best investment minds in the country when structuring our clients portfolios. GEM Capital sources information from several reliable sources, rather than relying on one broker or one research team.

We meet regularly, face to face, with leading institutional investors as well as digest a large volume of reading on a daily basis.

Our main focus is to buy high quality investment assets first, and secondly, try to buy them at a sensible time. We are not fortune tellers and are therefore unable to pick the tops and bottoms of markets. We can however determine quality. Those who buy quality investments but slightly overpay, will still generate reasonable returns over time. Conversely poor quality investments, (eg with too much debt, not profitable, poor management, unsustainable industry sector) may not be healed by time.

This report provides an introduction into how we think about investing within each of the major asset classes.

Cash and Fixed Interest

Cash and Fixed Interest investments are debt instruments where investors are lending their money to Banks, Governments or Corporations. Lending money to others generally attracts a lower return than owning assets such as companies or property. So while cash and fixed interest investments may offer inferior returns, it is important to understand the purpose of owning them in the first place.

The role of cash and fixed interest is to provide greater certainty and security of being able to access money when it is needed. Generally we suggest investors keep cash and fixed interest investments of between 3 – 5 years of what is required from their investment portfolio.

For example, a couple who is receiving a defined benefit super pension of $30,000pa (ie from Super SA), but requires income of $50,000pa, should think about holding $60,000 - $100,000 in cash and fixed interest investments in their portfolio. This level can then provide 3 – 5 years worth of the income required from their investments with great certainty, rather than having to potentially sell other longer term investments during downturns to fund their income.

Given the reason to own cash and fixed interest is to ensure ready access to cash when investors require it, we will look for investments in this sector that do not take on much risk and most investments we recommend in this sector would be considered ‘plain vanilla’.

For example, Greek Government bonds are paying interest at a rate which is a few percent above that of Australian term deposit rates. The upside for investors in Greek Bonds is potentially a few extra dollars in additional income, but the downside could be unlimited if the Greek Government defaults on their debt (which occurred following GFC).

How do we think about investing?

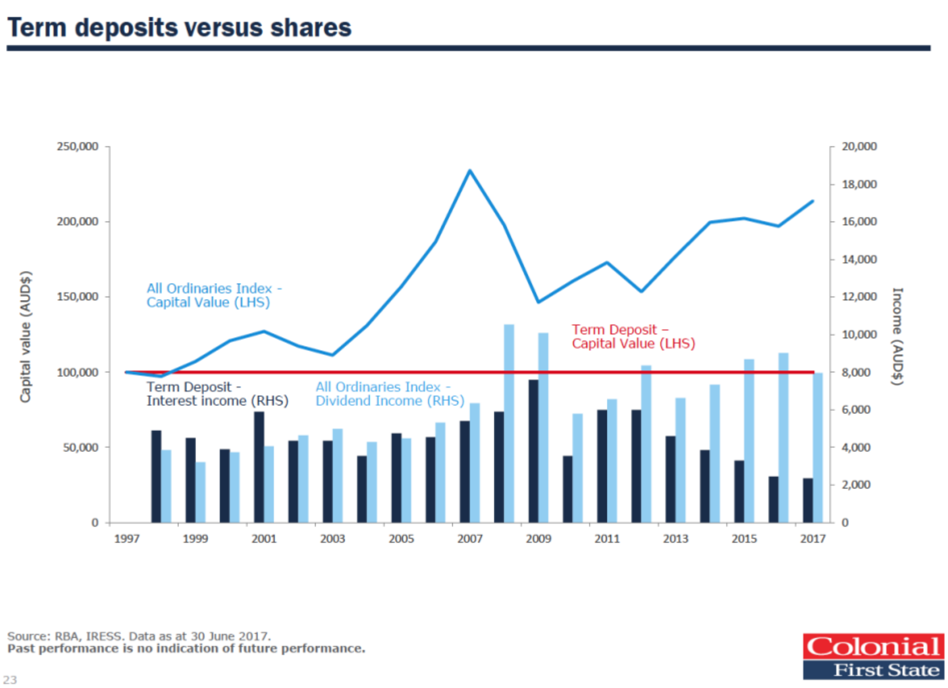
Australian Shares

We look at owning shares in a company as if we are part owners of the business. For example Woolworths share holders are joint owners of that business and as a business owner will share in the success or otherwise of that company. We encourage our investors to think about their shares as if they are part owners, rather than just passive investments.

If you were to consider buying a local business you would want to consider the following:

- Business has recurring income (rather than relying on 'one off' sales)
- Reputation of the business
- Management (we source this information from institutional contacts)
- Industry that the business is in (eg wouldn't want to own a video rental store)
- Debt levels (we look for companies not carrying excessive debt)
- Financial Accounts & Price of Business (we look for consistency of earnings and to pay a reasonable price)

And so, by extension, these are some of the aspects we consider when making share recommendations. Share holders can profit from owning companies in two ways. Firstly, through receiving dividends paid out of company profits and secondly through the share price. What ultimately drives dividends and share prices is company profitability so it makes sense that the greater profit a company makes, the higher dividend can be paid and the more that investors are willing to pay for the company. The chart below compares owning Australian shares to a term deposit over the past 20 years both in income received as well as the capital value.



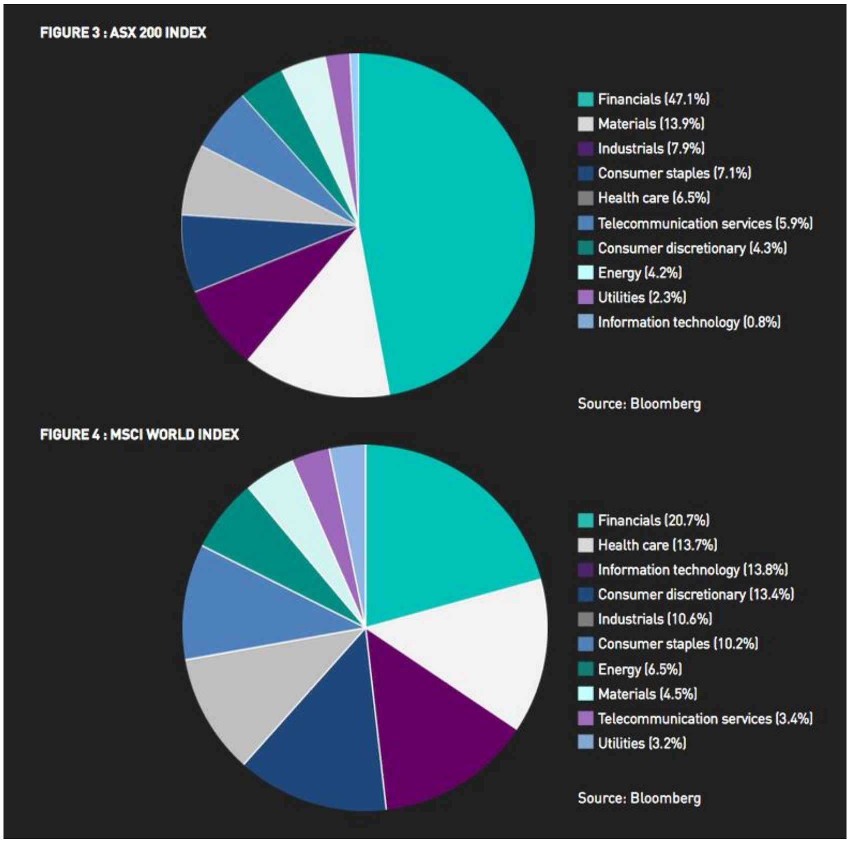
We advise our clients on shares they directly own, as well as investments in managed funds. The fund managers we recommend tend to share the above philosophy.

How do we think about investing?

International Shares

One of the most significant deficiencies in Australian investors is their home bias. Evidence of this is seen from ATO information relating to Self Managed Super fund (SMSF) investment strategies which shows International investing by SMSF's is virtually non-existent.

One of the attractions to investors of Australian shares are fully franked dividends, but investors can also invest in International listed investment companies run by some excellent Global investors, such as Platinum Asset Management, that also pay fully franked dividends.



Our concern for investors not looking outside of Australia is that they are ignoring some very profitable and fast growing sectors such as technology and healthcare.

At the same time those investors with a domestic bias are concentrating their investments on very few industries. The chart to the left shows the composition of the Australian share market (ASX 200) compared to the composition the Global market.

The ASX 200 is dominated by financial companies such as banks (47%) followed by the materials sector (mining companies) at 13%.

This means that those investing in the ASX 200 can be relying on the fortunes of two industries for the majority of their investment, which is at odds with one of the most common investment strategies of not putting too many eggs in one basket.

GEM Capital encourages investors to gain exposure to International markets through investing in well run managed funds or listed investment companies.

We live in a global world today, that is hugely interconnected. What happens in Europe, China or America for example is very relevant to investors on the other side of the globe. One of the other benefits of our relationships with Global fund managers is the ability to access information about global events and their likely impact on our investors.

Historically we have drawn on Global expertise to consider the impact of Brexit, Amazon entering Australia and the Italian banking system problems (just as some examples). These articles can be found on our website.

Understanding global trends can be very beneficial to enhancing returns for Australian investors.

How do we think about investing?

Property (listed or unlisted property trusts)

One of the attractive qualities of investing in property is regular income that is normally higher than that on offer from cash and term deposits.

There are two general categories of investment property (other than owning a property directly of course):

- Listed Property Trust – A unitized portfolio of property assets, listed on a stock exchange, usually the Australian Securities Exchange (ASX), resulting in the trust being able to be bought and sold, OR
- Unlisted Property Trust – similar to a listed property trust, but is NOT listed on the ASX. This means that the trust usually operates for a specific term, and withdrawals by investors are at the discretion of the trust itself.

Generally unlisted property trusts have higher gearing than their listed counterparts and many unlisted property trusts have only one property in the trust or are not well diversified. Both of these issues increase risk in our view. These reasons and the lack of liquidity to redeem funds from them puts us off unlisted property trusts.

The listed property trust sector is comprised of:

- Retail property (ie shopping centres)
- Office property
- Industrial property (ie large sheds for warehousing goods)
- Special purpose property (ie child care centre or medical centre)

The Australian listed property market is concentrated and dominated by retail property trusts, therefore we generally do not use managed funds (which tend to replicate the market) for exposure to listed property.

Our preferred sector is industrial property as generally the income is higher and the required level of capital expenditure to maintain the property is lower.

The key criteria we consider when selecting listed property trusts include:

- Gearing below 40%.
- Geographic diversity of properties (eg not all concentrated in one state).
- Spread of tenants that are of high quality, we don't want to be exposed heavily if one tenant became insolvent.
- Lease expiry period, or how long have the leases got left to run – this is commonly referred to as Weighted Average Lease Expiry or WALE. A short lease expiry increases risk should the lease not be able to be renewed.
- Generally avoid regional property due to reduced secondary market in those regions

How do we think about investing?

How are investments owned by our clients?

It is important from a security perspective that our clients own their own investments in their names, with their own contact details recorded against them. This is important so our clients know that no transactions can take place without their knowledge.

The other important aspect about our relationship with our investors is that our investors make the final decision. Our role as investment advisers is to provide recommendations and reasoning to support our recommendations, but it our clients' money and they make the final decision. We advise, you decide.

Our house broker is currently Bell Potter, and we recommend our clients establish a CHESS sponsorship with Bell Potter. This means that any listed assets (shares, listed property trusts and other listed assets) are all held within the one CHESS agreement where tax file numbers and dividend instructions are made automatically each time a new asset is purchased.

We normally recommend clients establish a Cash Management Account with Macquarie Bank. This account earns a competitive rate of interest, but more importantly acts as the hub to settle all transactions and receive income distributions and dividend payments. This results in the Macquarie Cash Management Account then becoming a valuable audit trail tool. Online access is available for this account, and the Macquarie phone application is very good.

You will generally not find us participating in the latest fads, such as crypto-currencies. We are however continually assessing the investment landscape for new opportunities that arise.

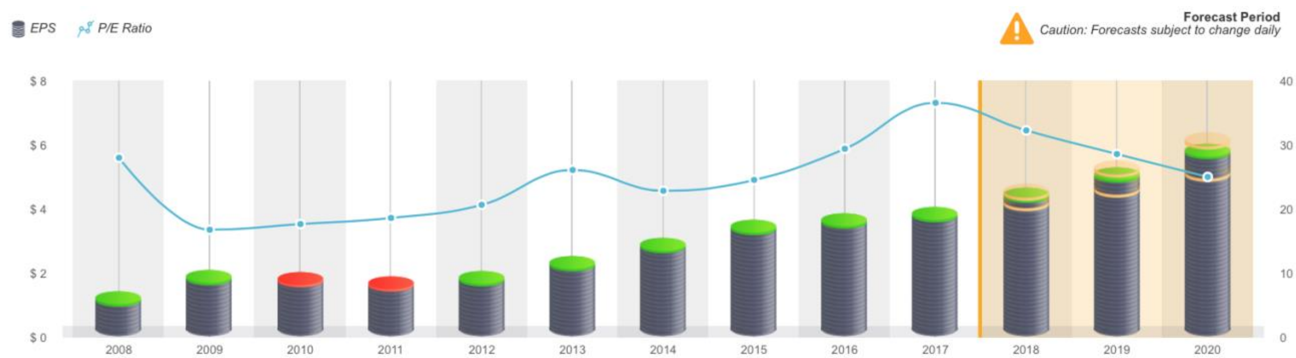
Our preference is to avoid "Investment Platforms" which are common place in the investment community. An investment platform is a 'middle man' which administers your investments, promising to provide a consolidated tax summary. This 'middle man' isn't free however and we do not currently recommend their use in order to reduce holding costs, and we also believe that ASX execution of buy and sell orders through these platforms is sub-standard.

Case Study – CSL vs Santos

The chart below shows the earnings per share (EPS) of CSL, one of Australia's most successful healthcare companies over the last 10 years. There has been great consistency in CSL's ability to grow their earnings, which has been rewarded in a significant rise in it' share price from around $35 to over $140 per share.

CSL has strong management, reasonable debt levels, high levels of recurring income and is a market leader in an industry that should grow courtesy of the global ageing of the population, all good qualities to look for.

CSL Earnings Chart



Years	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Earnings Per Share	$ 1.27	$ 1.92	$ 1.85	$ 1.74	$ 1.91	$ 2.36	$ 2.93	$ 3.50	$ 3.69	$ 3.89	$ 4.50	$ 5.13	$ 5.85
Market Price	$ 35.51	$ 32.15	$ 32.68	$ 32.30	$ 39.42	$ 61.58	$ 66.94	$ 85.85	$ 108.36	$ 142.07	-	-	-
P/E Ratio	27.99	16.77	17.65	18.61	20.65	26.09	22.83	24.53	29.39	36.56	32.26	28.57	25

Santos, by contrast, is a company that has endured many problems over the past 10 years including very high levels of debt, senior management turnover, lack of recurring income given it must continually make new discoveries to replenish its reserves, while operating in an industry that is likely to be disrupted by electric cars.

These problems are evident in the earnings chart below, as well as being reflected in the share price depreciation over that time.

Santos Earnings Chart

Years	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Earnings Per Share	$ 0.53	$ 2.15	$ 0.52	$ 0.67	$ 0.86	$ 0.56	$ 0.48	$ 1.20	$ 1.02	$ 0.42	$ 0.20	$ 0.22	$ 0.28
Market Price	$ 11.30	$ 11.42	$ 12.19	$ 11.49	$ 10.66	$ 9.67	$ 12.76	$ 7.14	$ 3.78	$ 4.02	-	-	-
P/E Ratio	21.33	5.32	23.26	17.03	12.35	17.14	26.63	5.93	3.71	9.46	25.64	22.73	18.52

A Little About Us

GEM Capital Financial Advice is a boutique financial advice business which is privately owned and aims to deliver highly researched and considered financial advice, that is backed up with friendly personal service.

The owners of GEM Capital have been advising clients since the 1980's and it is our experience plus the fact that we are <u>not</u> owned by a financial services product provider, which should bring peace of mind to our investors. Usually we are co-investors alongside our clients and every quarter we disclose all investments owned by GEM Capital advisers.

We take the responsibility of managing our clients money very seriously, but aim to have fun at the same time.

Our team has been together for many years with every one of our team members having over 10 years experience with GEM Capital Financial Advice. This doesn't happen by accident as we not only aim to carefully look after our clients, but also our team.

Draper Financial Services Pty Ltd trading as GEM Capital Financial Advice and its advisers are authorised representatives of GEM Capital Financial Advice Pty Ltd ABN 40 620 781 526 AFSL 502836.