Fountainhead Investor Letter No. 7 - June 2013

Launch 14 Feb 2012	MSCI World	Fund NAV
28-May-13	1 497.13	1.409
Perf. since inception	17.5%	40.9%
Last 6 months	15.2%	29.8%
YTD	11.9%	16.3%

Sector	Weighting (%) Fund
Energy	20
Materials	5
Industrials	0
Consumer Discretionary	24
Consumer Staples	0
Health Care	0
Financials	41
Information Technology	0
Telecommunication Services	9
Utilities	0
Total Shares	**99**
Cash	1
Total	**100**

Geographic	Weighting (%) Fund
North America	99
Europe	0
Japan	0
Other	0
Total Shares	**98**
Cash	1
Net Assets	**100**

Market Commentary

"Its impossible to produce superior performance unless you do something different"

Sir John Templeton

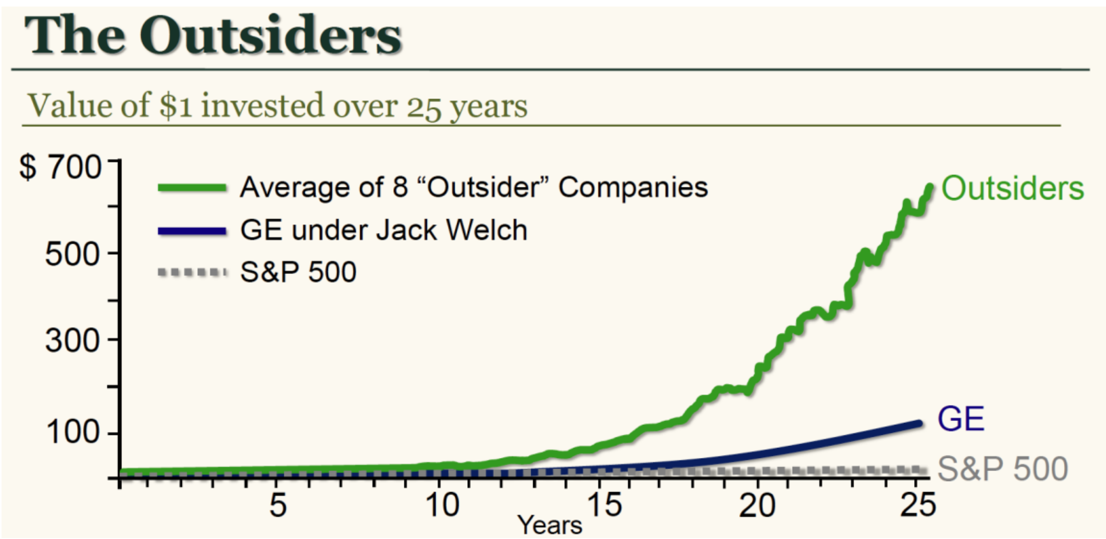
"I'm willing to go any place where we can tell how things are going to be in five years and management and all the things we emphasize. We've never foreclosed anything but are going to find most opportunities in the USA"

Warren Buffet annual shareholder meeting 2013

"We don't really start out looking to either emerging markets or industries or anything of the sort. We may find things as we go around, but it's not like Charlie and I talk in the morning and say it's a particularly good idea to invest in India or China or whatever the case may be. We've never had a conversation like that. It won't happen. It's not where our strength is. Know it's not there. Think probably most people's strength isn't there. It sounds good but it's not the best way to look at investments"

Warren Buffet annual shareholder meeting 2013

I recently read "Outsiders" by William Thorndike, which I regard as probably the best management/investment book written in the last 20 years. Recently Charlie Munger recommended the book. Another invaluable read is Charlie's favourite book "influence" by Professor Robert Cialdini, which I'll elaborate on another time.



Source: The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success – by William Thorndike 2012

The book begins with a simple question, "Who's the greatest CEO of the last 50 years?"

The name Jack Welch would pop in to most people's minds given the amount of mainstream media attention he has received. Welch was a very successful CEO. If you invested $1 in GE stock when he was appointed CEO in 1981 you would have had $48 by the time he handed over the reins in 2001.

The book however profiles 8 CEO whose performance dwarfed that of Welch and the market overall.

The point is made that performance should be measured relative to ones peers, not merely the market.

The difference is the ability of the unconventional group to focus on capital allocation relative to the business operations. Capital allocation might just be the most important attribute for a CEO, yet business schools offer very little on the subject.

"The heads of many companies are not skilled in capital allocation. Their inadequacy is not surprising. Most bosses rise to the top because they have excelled in other areas such as marketing, production, engineering, administration or sometimes institutional politics. Once they become CEO's, they must now make capital allocation decisions, a critical job that they may never have tackled and that is not easily mastered. To stretch the point, it's as if the final step for a highly talented musician was not to perform at Carnegie Hall, but instead, to be named Chairman of the Federal Reserve" – Warren Buffett

Investors in today's market are purely focused on searching for yield, in the form of dividends. We believe this logic is flawed.

"After the 10 years on the job a CEO whose company retains earnings equal to 10 percent of net worth will have been responsible for the deployment of more than 60% of all capital in the business" Warren Buffett

Focusing narrowly on dividends rather than management skill at capital allocation is a very dangerous way of going about protecting ones capital. These investors forget that it's total return that matters (Capital gains PLUS dividends). I think the next few years will prove very unrewarding for investors with this partial view of the return equation.

The same set of investors that focus on dividends often deride the impact of buybacks, yet all the CEO's in the book bar one employed buybacks on a large scale with John Singleton retiring 90 % of the outstanding shares. The one outlier interestingly is Warren Buffett himself although it must be pointed out that he recently started employing this tactic. The point is that if one looks at buybacks through a capital allocation lens there are times they make an enormous amount of sense from a value creating perspective.

The amazing thing about this book is how each of the CEO's turned out to be iconoclastic (def: One who attacks and seeks to overthrow traditional or popular ideas or institutions) in virtually identical ways.
Some of their core common beliefs were

- Capital allocation is a CEO's most important role.
- What counts in the long run is the increase in the per share value, not overall growth rates.
- Cash Flow - and not reported earnings - is what determines long-term value.
- Decentralized organizations release entrepreneurial energy and keep both cost and "rancour" down.
- Independent thinking is essential to long-term success and interactions with outside advisors can be distracting and time consuming.
- Sometimes the best investment opportunity is your own stock.
- With acquisitions, patience is virtue… as is occasional boldness.

Something I found striking was that their iconoclastic approach was reinforced by their geography. All these individuals operated in cities like Denver, Omaha, Los Angeles, Alexandria etc and not financial epicentres of New York or Boston. Their location allowed them to insulate themselves from the Wall Street ***conventional wisdom.***

Another common characteristic was that these investors (probably due to their iconoclastic ways) weren't very well known and tended to fly under the radar for years despite producing such superior returns. They were definitely not in the same mould as a modern day Donald Trump.

Some other common characteristics

- All were first time CEO's
- All but one were new to their industries
- Half were below forty when they took the job

They were therefore not bound by prior experience or industry convention.

A quote from the book (Outsiders)

In his recent bestseller , Outliers, Malcolm Gladwell presents a rule of thumb that expertise across a wide variety of fields requires ten thousand hours of practise …… Certainly none of these CEO's had logged close to ten thousand hours as managers….perhaps their success points to an important distinction between expertise and innovation

The last chapter of the book deals with Warren Buffett who is the undisputed world champion of investing. $1 invested in Buffett when he acquired Berkshire is worth $6265 forty-five years later. What amazes us is how despite the fact that 35 000 plus people go to Omaha each year almost none of those practise what he continuously preaches. Once they leave Omaha they go back to towing the conventional wisdom line as espoused by main stream finance “experts” on a daily basis.

You may ask at this point what this has to do with the fund and the money you have entrusted to us.

Most conventional asset managers would regard us as iconoclastic (although we have simply replicated what the great investors demonstrated to be the best way to produce superior returns over time) in the way we run our collective capital. We do not subscribe to the conventional wisdom of the current asset management environment.

Below are the 5 core principles to which we adhere. They are directly opposed to current conventional wisdom

1. Preservation of capital first and foremost, through the rigid application of the concept of margin of safety. For a stock to be included in the portfolio it must trade at price/intrinsic value (P/V) of less than 0.6. If the conservative assumption is made that intrinsic value grows at 5% per annum and the price reverts to intrinsic value over a 5-year period, this will provide a minimum 15% compound annual return over the holding period.

2. We concentrate our capital in our best ideas (at all times we will hold between 5 and 20 companies, we currently hold 7). Our stocks have the highest margin of safety from a quantitative perspective and the companies are of the highest quality from a competitive standpoint, produce superior returns on capital and have management teams with long term track records of shareholder value creation. We strive to buy companies where the interests of management and the shareholder are directly aligned.

3. We take a minimum 5 year view on our stocks, which allows us to take advantage of excellent value opportunities. These stocks are normally over-looked by the market due to its short-term focus. This results in very low portfolio activity.

4. Our focus is absolute return in nature, as is our fee structure. Our hurdle rate is 4% per annum, above that we share in 20% of the profit. Having an absolute return mind-set ensures that we do not fixate on what is doing well in any given index and rather on what we believe will provide the best long-term returns. We only share in the upside if we compound partners' capital in real terms. If we cannot find investments that meet our min 15% p.a. margin of safety target we will not invest capital and remain in cash until we find investments that do meet this crucial requirement.

5. We believe firmly in the concept of "eating our own cooking". The fund is the

only financial investment which we as managers hold and performance fees we have earned to date have been reinvested in the fund.

Once again I quote Mr Buffett

"We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort level he must feel with its economic characteristics before buying it"

He thus describes his investment activity as *"inactivity bordering on sloth"*

"If you took out our top fifteen decisions, we would have a pretty average record. It wasn't hyperactivity, but a hell of a lot of patience. You stuck to your principles and when opportunities came along, you pounced on them with vigor."
- Charlie Munger

Despite the obvious simplicity and rationality of the statements above we meet clients and client advisors on a daily basis who label us as risky. They would rather allocate capital to alternative sources, such as "safe" high dividend paying stocks. We will NOT change our investment process to attract capital as this would sacrifice superior long-term returns. We will continue to fly under the radar, focussing on return maximisation as opposed to fund size.

We remain extremely confident in the return potential of our portfolio companies. Our trading is particularly slothful currently. We are always searching for even better ideas, but are unable to match our current combination of some of the most competitively advantaged companies we have ever seen. At an overall price / intrinsic (P/V) of 0.28 on our measurement we are finding it exceedingly difficult to find anything else that comes close to the appeal of our current holdings.

The next letter will focus on some of the reasons why conventional wisdom plays such an influential role in not only investing, but our everyday lives. We'll refer to Charlie Munger's favourite book "Influence" by Professor Robert Cialdini. (a must read)

Due to the length of this letter we are offering the first five partners who send us an email a free copy of the "Outsiders", it's my sincere hope that we receive at least five e-mails!

Yours in value

Fountainhead Partners

DISCLOSURES

Manager: Stonehage Fund Services Limited , No2 The Forum, Grenville Street, St Helier, Jersey JE1 4HH, Channel Islands.
Administrator: Stonehage Fund Services Limited , No2 The Forum, Grenville Street, St Helier, Jersey JE1 4HH, Channel Islands.
Investment Advisor: Andre Cillie Capital Management (PTY) Ltd

Fountainhead Expert Fund IC (the "Fund") has been established as an 'Expert Fund' as described in the Jersey Expert Fund Guide (the “Guide”) published by the Jersey Financial Services Commission (the "Commission") and is suitable only for investors who fall within the definition of an 'Expert Investor' set out in the Guide.
No person is authorised to give any information or to make any representation in connection with the issue of shares in the Fund which is not contained or referred to in the Fund’s Prospectus and, if given or made, such information or representations may not be relied upon. The distribution of the Fund’s Prospectus and the offer and sale of the shares in certain jurisdictions may be restricted by law. Please note that due to the concentrated nature of the Fund it is not authorized or regulated by the FSB in South Africa and, as such, the information contained in this letter is intended only to provide salient information regarding the fund and does not constitute an offer or an invitation to any person, whether a member of the public or not, to acquire an interest in the fund.