

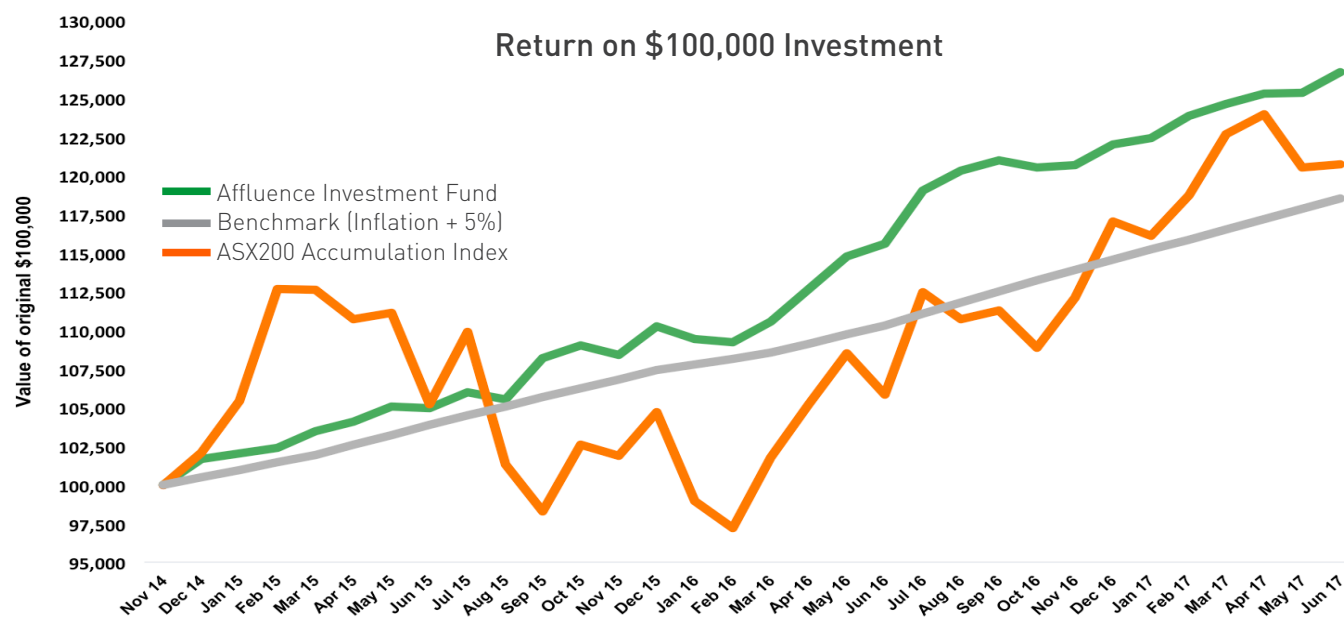
Affluence Investment Fund

2017 Annual Investor Letter

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What really matters?

Take a moment to review the graph below carefully.



This graph, or a version of it, appears on our website and almost every report, flyer and presentation we release. Why is it so important? Because it neatly encapsulates what we're all about. Above average returns. With as much consistency as possible. Or put even more succinctly, performance with low volatility. I've expanded on each of those topics, plus some other themes we think are important, below.

Fund performance

The graph compares our returns against two key measures. The first is our return target (or benchmark) of inflation plus 5%. Since inflation has averaged around 2.5% over the last 15 years (currently it's lower), this means on average we're looking to beat 7.5% per annum. We aim to pay income (through monthly distributions) of at least 5% per annum, and to grow the portfolio value net of fees and costs, by at least inflation.

This is a target that we and many others believe is a tough, but achievable long-term goal for a balanced investment portfolio. That surprises a lot of people, who overestimate long-term investment returns, and hence have too high an expectation for their own future returns. By way of example, according to Chant West, the average balanced super fund has delivered just 6.4% per annum over the past 15 years. Bear this in mind when setting your own investment goals.

As you can see from the table below, we exceeded our target by around 2.8% per annum since the Affluence Investment Fund commenced in late 2014. That is, we've delivered total returns of 9.6% per annum compared to the benchmark 6.8%. We've been helped slightly by lower inflation over that period - just 1.8% per annum, which has given us a lower benchmark to beat. Nonetheless, we have beaten it comfortably.

As an aside, we've also outperformed our income target since we started, providing monthly distributions at an average of 7% per annum. The excess above our 5% per annum target was mostly paid in June of each year, driven by realised gains on our investments.

To 30 June 2017	1 Month	6 Months	1 Year	2 Years	Inception	Volatility
Income Distributions	2.1%	4.2%	7.0%	5.3%	7.1%	
Capital Growth	(1.0%)	(0.3%)	2.6%	4.6%	2.5%	
Total Return	1.1%	3.9%	9.6%	9.9%	9.6%	3.1%
Benchmark - Inflation + 5%	0.6%	3.5%	7.4%	6.8%	6.8%	
Outperformance against Benchmark	0.5%	0.4%	2.2%	3.1%	2.8%	

Total returns are net of fees and costs (excluding buy-sell spread) using the mid prices and assume the reinvestment of distributions. Returns for periods of more than 1 year are annualised. Past performance is not indicative of future performance. Inception date is 28 November 2014. The Fund aims to pay distributions of approximately 5% pa paid monthly. Distributions are not guaranteed and may be paid above or below this amount.

These returns are after all fund costs and expenses, but before tax. They also exclude franking credits, which have averaged an additional 0.4% per annum. We're very pleased with these results. But so far it's only been two and a half years. We haven't yet been tested over a full investment cycle, or an all-out bear market, or even our minimum suggested investment period of 3 years. So we're happy. But Greg and I are not patting ourselves on the back too heartily just yet.

Our secondary return comparison on the graph above is the most quoted Australian stock market index, the ASX 200 Accumulation Index. It reflects the size-weighted returns of the 200 largest and most liquid stocks on the ASX. It includes dividends, but not franking credits. It's a very tough target to beat over the long term for a fund like ours. But it's worth aspiring to. So far, we've also comfortably beaten that index, although I suspect that will not always be the case. But we aim to deliver our returns with much better consistency than the stock market, which brings us to the third important point about the graph, volatility.

Why volatility matters

Volatility or more specifically low volatility, is a very desirable characteristic of an investment. Think of volatility as the level of variability or lumpiness of returns. Low volatility means consistency. In the case of most of our investors, even if the other returns in our graph were equal, they'd rather own the green line than the orange one. It helps you sleep better.

Low volatility is important for one other very good reason. It helps to avoid us all doing dumb things. Here's an example. One of the best managers in our portfolio has delivered exceptional returns of around 15% per annum for over 15 years. But in 2009 their fund fell in value more than 65%. That means if you had an investment in that fund worth \$100,000 at the peak of the market in 2008, it would have fallen to be worth slightly less than \$35,000 at some point in 2009. These guys are unbelievably good managers. But we don't know too many investors that wouldn't have panicked and sold at some point on the way down. We know even less that could have bought more anywhere near the low point. By 2011, they'd recovered all the losses and more. But we suspect very few people could emerge from that experience unscathed, with their investment capital still intact.

Volatility is most commonly expressed as a number. It's measured by way of a complicated mathematical formula called standard deviation. The higher the number, the more wildly returns fluctuate. Some examples may help. A bank account or term deposit paying monthly interest at a regular rate has a standard deviation of close to zero, assuming of course that you get your money back from the bank at the end. A relatively stable portfolio of bonds might have volatility of 2-3%. Our Australian stock market volatility has averaged 10-15% over the past few years, slightly higher than the US market. A small cap portfolio of resources or biotech stocks might have volatility of 20-30%. The basic rule of thumb is that the higher the potential returns, the higher the volatility. High returns, with low volatility are the holy grail of investing. A ratio of 1:1 (say 8% returns with 8% volatility) is considered very, very good.

The statistic we're most proud of is that since commencement, the Affluence Investment Fund volatility has averaged just 3.1%. So, we've delivered returns better than stocks, with low volatility of bonds. You can see this on the graph. While the orange line has fluctuated quite a lot, falling almost 15% at one point in 2015, the green line has stayed very stable.

Another way of looking at volatility is the monthly returns of the Fund. As you can see below, there's much more green than red. And that's the way we like it. More importantly, that's the way most investors and financial advisors like it.

Fund Monthly Return History

	J	F	M	A	M	J	J	A	S	O	N	D	Year
2014												1.7%	N/A
2015	0.3%	0.4%	1.1%	0.6%	0.9%	-0.1%	1.0%	-0.5%	2.5%	0.7%	-0.6%	1.7%	8.4%
2016	-0.7%	-0.2%	1.2%	1.9%	1.9%	0.7%	3.0%	1.1%	0.6%	-0.4%	0.2%	1.1%	10.7%
2017	0.3%	1.2%	0.6%	0.5%	0.1%	1.1%							

Strongest Month
 Positive Month
 Stable Month
 Negative Month
 Weakest Month

It's important to point out that it won't always be this way. We will be buffeted by very large market corrections from time to time, possibly even negative years. But if we do our job right, we'll be knocked around a lot less than most. And, such an event will most likely provide us with a large range of very attractive investment opportunities, something that has sadly been missing over most of the past 12-18 months. We aim to be ready for that opportunity when it occurs.

We're often asked how we've managed to keep volatility so low. There's lots of reasons. But the one thing that we believe has mattered more than anything else is what we call style diversification. We try, as one of our basic rules, to construct a portfolio of funds and managers that can deliver better than average returns over the long term. But we try just as hard to make sure that they outperform at different times. And because we have a focus on making sure we outperform most when markets are falling, we focus on finding managers that can add value in bad times.

Key diversifiers in our portfolio have been our long/short and market neutral funds. These investment styles can be difficult for investors to fully understand. And month to month returns can be unpredictable. But they can help a lot when markets are falling and you've got your back against the wall.

While we haven't been fully tested yet, the results so far have comfortably exceeded our expectations. Of course, that doesn't mean we'll never lose money. But if we do our job properly, we'll lose a lot less than everyone else in down markets.

What has worked

We're pleased to say our results have been positively impacted by a few key things we've done well. In addition to finding great managers and style diversification, the following things have contributed positively to our results:

1. Refuse the mediocre

We refuse to accept returns below our target, just to achieve diversification benefits. It's why you haven't seen any high-grade bond funds in our portfolio at any time in the past two and a half years, and why you're unlikely to any time soon. You'd be surprised how many others break this rule and accept returns close to zero, to potentially reduce risk.

2. Discretion to do what we think is right

We allow ourselves a wide investment mandate, including the ability to hold cash and use options to protect the portfolio if we see fit. This, quite simply, gives us the ability to always do what we feel is right, without unnecessary constraints.

3. Avoid losers

The managers we invest with have done an exceptional job over the past two and a half years. We've trusted them with ours and your hard won investment dollars. With very few exceptions, they've performed admirably. They deserve our thanks, and our respect.

4. LICs

Through our Listed Investment Company portfolio, we're able to not only access some great managers, but also take advantage of other factors such as abnormal share price to NTA discounts and corporate actions to boost returns.

5. The intangibles

With our manager selection, we put much of this success down to the intangible part of our process. The part where we meet face to face with fund managers and try to figure out if they're made of the right stuff. And the good news is that many, many of them are. There is a great amount of talent in our Australian funds management industry. It's a pity that product distribution is strangled by big institutions, who are incredibly poor at recognising opportunity and even worse at making it available to their clients.

Top 10 Largest Investments at 30 June 2017

Cash	Alexander Credit Opportunities Fund
Affluence LIC Fund	Packer & Co Investigator Trust
Phoenix Opportunities Fund	Microequities Deep Value Microcap Fund
Cromwell Direct Property Fund	Bronte Capital Amalthea Fund
Wentworth Williamson Fund	Ophir High Conviction Fund

What have we learned (what hasn't worked)

Any investor worth a dime will tell you they learn more from their mistakes than their successes. We never give up on the chance to continually refine, improve and learn. So, what have we learned over the past 12 months? Here's some things we think we can do better.

1. Performance chasing is an ever-present threat

The temptation is always to chase last year's big winners. Often, that ends badly. We were guilty of this more than once over the past year or two, and we will be again. We continue to refine our process around timing and position sizing. Our goals with timing are not lofty. We seek merely to get it more right than wrong. But if we can do that, we'll both add value and be ahead of at least 75% of the investing community.

2. Not backing ourselves enough

I mentioned earlier that it's been a tough year to find exceptional investment opportunities. We've found a handful of pretty good ones over the past 12 months. But in every case, we've invested less than we should have. Usually, we've allocated around 1-2% when we should have allocated more. Near term uncertainty and volatility led us to be conservative with position sizing, as we should be. But we were a little too conservative. The cheaper something becomes, the harder it is to buy more. But if you're right in your analysis, that's exactly what you should be doing. We'll continue to work on this one, although you'll never see us take large concentrated bets in this Fund.

3. Missing out

We've seen opportunities that we've passed on, go on to deliver exceptional returns. And we've missed some altogether. We try to analyse the reasons for this where we can. Quite often where we've passed on something, it's entirely justified. Sometimes, returns are very good, but the risk that it could have gone wrong was not something we were prepared to tolerate. Just because it worked out well this time, doesn't mean that we made a mistake. We'll almost always pass on opportunities which exhibit very high gearing, require leverage to achieve acceptable returns, involve very high transactional costs or a strategy we simply can't understand. Some of these succeed spectacularly. But in big market corrections, many will fail spectacularly. And a big part of achieving great long-term returns, is avoiding any spectacular failures in your portfolio.

4. Being too conservative

We carried a little too much cash for most of the last year. We underestimated how resilient our portfolio was, and we were a little too quick to declare markets overvalued. We're working on building more useful indicators into our process, particularly sentiment and confidence measures. At the end of the day, markets respond to human behaviour which is, to at least some extent, measurable.

The hardest lesson of all

I started relatively late in the investment game - in my mid 20's. Luckily three things helped me learn more quickly than others might. Firstly, I was an accountant by trade, which helped grasp the analytical side of investing relatively quickly. Secondly, I was lucky enough to be mentored for over 10 years by some fantastic investors within a very successful and growing business. And finally, just when I thought I knew it all at the ripe old age of 38, the GFC came along and taught me many more lessons that will stay with me for life.

Through all of that, the hardest skill of all to learn has been patience. The patience to sometimes look at 100 things, analyse 10 closely and only invest in 1. Or none. The patience to recognise returns occur over 3-5 years, not 1-2 months, and to plan and invest accordingly. And the patience to recognise that markets move in long cycles, and that buying way too early and selling way too early are just another way of being wrong.

We are disciplined buyers. But if we get our calls right, we'll also be long term holders. I'm pleased to say that out of our 25 or so unlisted investments, we've redeemed just two in the past 12 months. In both cases, the performance of the manager was not terrible. In fact, it wasn't even negative. It's just that we found even more compelling opportunities in the same space.

Patience is also a two-way deal. We manage funds where every investor is free to take their money back every month. It is therefore extremely important to us that we attract investors who are, like us, patient, philosophically aligned and have realistic expectations. We focus on this very strongly. It's led us to limit the flow of investor funds coming in to our investment funds. Right now, we manage just a tiny drop in Australia's funds management ocean. But we've had new investors join us every single month, and to date not a single investor has withdrawn.

Over the next 12 months, we are targeting to grow our funds under management (FUM) by just \$20 million. We have potential demand for many, many times that amount. We'll take more, but only if we are almost certain that we can put it to work without disrupting returns for our existing investors. We're controlling not only the total value of funds we manage, but the rate at which FUM grows. It's a novel approach in Australian funds management, to limit inflows at such a small size. But we've seen too many managers be negatively impacted by surging inflows, to want to do it any other way.

We're confident that in 10 years' time we'll be managing many hundreds of millions. But we'll get there at our pace. Consistently and methodically. And always looking out for those who have already invested with us. You can help. If you're already invested with us, think about adding small amounts regularly. If you're thinking of investing, start small and grow over time. It helps you get to know us better as we become a larger part of your portfolio. And it helps us more efficiently put your money to work.

New investment opportunities

We commence every new fund by putting our own money in first. We open it to investors only when we've fully developed our investment process for that fund, and are confident we can deliver above average returns. We did it first with our Affluence Investment Fund. We followed that up with our Affluence LIC Fund in June, having run an LIC portfolio for nearly two years. We're incubating the Affluence Small Companies Fund right now. We will only open it when we believe there's value to be had.

We're likely to offer other investment options in coming years. But only when we see value. Our existing investors and subscribers will always be the first, and possibly the only ones to know.

We're also considering taking our products to market in differing structures. One of our enduring frustrations is the difficulty in accessing all potential investors through a single product structure. There are platform and dealer approved product list restrictions. There are cost and compliance barriers for retail funds and many other limitations. That makes it almost impossible to provide access to all, or even most Australian investors through a single product. The closest we could get is to have a listed version of one of our funds on ASX (a Listed Investment Trust). It's something we're quietly working towards and will do when we feel the timing is right. Please let us know if you'd be interested in learning more about that if it happens.

Predicting the future

We're often asked what we think will happen next in the investing world. We take it as a compliment that people think enough of us to believe we can predict the future. But before you accept our predictions (or anyone else's) as facts, you should know this:

- Great investors usually get 60% or less of their calls right.
- Economists are even worse.
- Markets are inherently unpredictable.

For these reasons, we never assume we know what will happen next. Neither should anyone else. It's why funds based on macro (economic) forecasts are some of the worst performers. We always construct at least 80% of our portfolio to be diversified enough to be able to handle as wide a range of good and bad outcomes as possible. We hold the balance of around 20% in cash and some smaller, but high conviction bets. This allows us to take advantage of exceptional value when it presents, but not to the extent we will hurt too much if we're wrong. Because we, like everyone, can be wrong often.

With that in mind, here's our thoughts on the current investing environment:

- This investment cycle is getting long in the tooth. But it's not yet time for it to end. We see things that concern us with increasing regularity. But we don't yet see the signs of exuberance we've seen in previous market tops. We believe there's a little way to go yet before any big correction takes place. But if we're wrong, we're prepared anyway.
- The pace of technological change is rapid and accelerating. That will fundamentally change the way almost everyone invests in the next 10 years. The range of ETFs now available is but one example of this. The big winners will be investors, as the overall cost of investing comes down and the amount of choice goes up. In the future, it will be much easier to sort through the range of opportunities to find the ones that work for you. The big losers? Our major banks and other large benchmark-hugging wealth managers. I won't spend too much time feeling sorry for them.
- That doesn't mean you should go out and buy the disrupters. FAANG and other technology darlings are very likely to fall substantially in the next 3 years, as substantial risks which are currently unknown, underestimated or ignored by the investing public, become reality.
- Residential property in Australia will become a poor investment one day. But probably not soon, and probably not when anyone's expecting it. When it does happen, it has the potential to be catastrophic, so watch carefully. Pay attention most to the rate of change on growth of residential loans. When credit slows a lot, markets and investors get hurt.

- The interest rate cycle has well and truly bottomed. Rates will trend higher for many years. Perhaps very slowly. Perhaps quickly. But they will be higher. Plan accordingly. In the meantime, continue to enjoy this otherwise underrated and underestimated economic miracle that is the Australian economy.
- The last 30 years have been a period of exceptional returns, driven by increasing debt. That free ride is unlikely to be repeated in the next 30 years. Achieving above average returns in the future will, more than ever, require investors to “invest differently”. That’s our mission, and it’s in our DNA.

Traditional Fund Managers	vs. Affluence - Invest Differently
Follow The Herd: Traditional managers are too scared to fail, so they don’t succeed. Most don’t outperform the index.	Actively Pursue Out-performance: From our fee structure alignment to our investment methodology, our strategy targets positive returns and low volatility.
Restricted Product Selection: Commonly places clients into their own managed funds or choose from a restricted list of ‘approved’ funds.	Best Of Breed: We will seek the best fund managers, and combine them in a way which cushions against market corrections.
Traditional Asset Classes: Manage large amounts in traditional asset classes (e.g. ASX200 equities), which minimises chances of excess performance.	Unique Strategies: We prefer managers who operate in specialised markets with less funds under management and a competitive advantage.
High, Fixed Fees: Take fees regardless of performance.	No Fixed Fees: Our fees are 100% performance based.

How are we positioning ourselves for the late-cycle environment? In short, we’re preferring investments which have upside optionality, or some downside protection, or both. Our investment philosophy means we will probably underperform if markets rise strongly from here. It’s a price we’re more than willing to pay.

Some thanks

I’d like to mention one more thing I’ve done right over the past two and a half years. Probably the most important decision I’ve got right for both Affluence and for our investors. In late 2015, Greg Lander approached me to see if he could join us in the Affluence team. Having worked closely with Greg for the best part of ten years, I jumped at the chance. And we’ve never looked back.

Greg has contributed immeasurably to our success and the quality of investment decisions so far. I believe the optimum investment team is two or three people who are philosophically aligned but think independently. Who each generate their own investment ideas and work well together. At Affluence, the work we do is very much a team effort. We don’t do anything unless Greg and I both agree. And while I occasionally have a hair-brained idea, it usually doesn’t make it past Greg. He deserves your unwavering support.

Greg and I are also helped by an expanding group of other contributors. Kane (who’s been a constant, if part-time, presence with me almost since day 1), as well as Kyle, Melynda and Kristen have all helped enormously in the past year. We couldn’t do it nearly as well without them. Just as importantly, we added Karen Prentis and Geoff Cannings to our Board as non-executive directors late last year. As board members, they perform an important oversight function. They also contribute fantastically to our strategic discussions and provide a great sounding board. I can’t thank them enough.

Finally, I’d like to thank you. Whether you’re an investor (or thinking of becoming one), an advisor, a subscriber, a fund manager or working with us behind the scenes, we value your comments, feedback and the work you put in. And we very much enjoy having you along for the ride. Affluence is all about bringing together good people who share our philosophy, and put our investors interests first.

I wish you all the very best in your investing endeavours over the coming year, and thank you for your support. It means a lot to us.

Regards,



Daryl Wilson

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