Letter to Investors

First Quarter 2019

Performance:

In US dollars, the portfolio increased by 16.76% before fees versus an increase of 13.07% for the S&P 500, 9.46% for the ASX 200 and 10.49% for the NZX 50.

The US dollar the base currency for the portfolio. The exchange rate between the Australian dollar against the US dollar had a positive impact of 0.21% on total returns.

Neutralised for exchange rates the portfolio increased by 16.55% before adviser fees.

Discussion:

According to CNBC, the 13.07% for the S&P 500 was best quarterly performance since 2009 and the strongest start to a year since 1998. Headlines like this undoubtedly get attention and leave commentators breathless. It should be taken in context that the year started at a low after a 20% market correction at the back end of 2018 (the market bottomed a few trading sessions earlier, on Christmas eve 2018).

Our portfolio benefitted from the market strength. It was pure happenstance that the lows of the market and the portfolio coincided with the start of a new quarter. For this reason, market returns of 13.07% and portfolio returns of 16.76% are unlikely to be repeated on a regular basis.

While there are pockets of the market that can be considered quantitatively cheap my view is that the market in general is priced at a premium. I consider it unlikely that the market returns over the next 10 years will be as strong as the previous 10.

Although, with persistently low interest rates we are not at bubble territory.

Portfolio Breakdown:

The portfolio can be divided into 3 sectors – US Stocks, ASX Stocks and Arbitrage Situations.

US Stocks:

We currently have 8 holdings in the United States, making up approximately 58.9% of the overall portfolio. This is an increase from 7 stocks and 40.8% of the portfolio at the beginning of the quarter. US stocks contributed a total return of 9.62% for the quarter.

Booking Holdings (BKNG):

The only change to the portfolio across our US and Australian holdings was the closing of our positions in Pushpay and Kogan and the purchase of BKNG. On a weighted basis BKNG is currently the largest position in the portfolio, accounting for approximately 15% of net liquidation value. I have spoken in detail on my thesis for investing in BKNG in my podcast that you can listen to by following the link below;

https://anchor.fm/stockmarketmovers/episodes/31--Booking-com--Profile-of-an-Industry-Leader-e3eoft

The company has a near monopoly business in key territories, has excellent management, is loved by its customers, has a solid balance sheet and is immensely profitable. I think the stock is undervalued currently relative to its prospects. In the five minutes that it has likely taken you to read this report I estimate that the company has delivered over five thousand room nights.

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ASX Stocks:

We currently have 5 holdings in Australia, making up approximately 28.2% of the overall portfolio. This is compared to 7 stocks and 41.8% at the beginning of the quarter. ASX stocks contributed a total return of 4.43% for the quarter.

As mentioned in the above commentary on BKNG we sold our positions in Kogan and Pushpay. Asides from those transactions our holdings in Australia remain unchanged.

Arbitrage Trades:

Arbitrage contributed positive 2.44% to the total return for the quarter. Arbitrage positions currently make up 32.6% of the portfolio value.

The arbitrage situations that I am looking for relate to takeovers. When a takeover is announced the stock of the company being acquired will generally increase to a level that is below the takeover price. The stock will normally trade below the takeover price because the market is pricing in the uncertainty that the deal will not go through. I assessed dozens of these potential transactions throughout the quarter, I am only looking to participate in transactions that I deem to have a high probability of proceeding and that we can make the margin from to make it worthwhile. I am happy to use a little bit of margin, up to 15-20% of the portfolio's value. It is important to note that if you are invested and you are unhappy with using margin then we can have it disabled.

I like these arbitrage trades due to a higher overall expectancy and that they are not correlated to the rest of the market. Arbitrage trades can also provide downside protection when the market is falling. For this reason, I will be continued to look for further arbitrage opportunities.

Earthport (EPO.L):

Most of the arbitrage trades that we participated in during the quarter were uneventful (which is just the way I like them!!).

The exception to this was the acquisition of Earthport (EPO) by Visa. EPO is a small cross border payments provider that is listed on the AIM exchange in London. Visa announced an acquisition of the company on the 27th of December 2018 for 30 pence per share. The stock jumped significantly, and we bought at 28 pence, expecting that we would sell it to Visa for 30 pence when the deal closed. Things got interesting when a month later Mastercard swooped in and offered 33 pence per share to buy the company and we had a bidding war. The market anticipating a bidding war pushed the stock to 39 pence before Visa sweetened their offer to 37 pence. The stock at this time ran up to nearly 50 pence per share as enthusiasm for the bidding war took over. On the 8th of March Mastercard withdrew itself from the 'auction' and the stock fell 25% to just under 37 pence (the level of Visas final offer).

So, what was Mastercard playing at? It did occur to me during the process that the 10% was a small premium to Visa's offer. I think that Mastercard were either trying to make their rival Visa pay more for the company or were just hoping to get due diligence on Earthport to keep an eye on what Visa were buying. My gut feeling afterwards was that this was never a serious bid by Mastercard. Even knowing this I would not have sold early. The reason for this is that the 37 pence offer by Visa set a 'floor' for the stock that was significantly above our buy price. The second reason is that at around 250 million-pound, Earthport is a tiny company and is literal

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cannon fodder for Visa and Mastercard. If a true bidding war had taken hold then the profits could have been large. It was worth the risk. As it turns out we are up over 30% on Earthport, 120% on an annualised basis.

Outlook and Future Reports:

The purpose of these reports therefore is for me to provide investors (current and potential) with the information that they need to gauge whether I can deliver a good performance over a longer period – this is the information that I would expect to be provided if the roles were reversed.

I was happy with the performance of the portfolio in the first quarter. Apart from the turnover in arbitrage trades I do not expect much change in portfolio composition during the first quarter.

Expectations:

Since I recently advertised the portfolio on the podcast there might be a few people who are reading these reports for the first time. For this reason, I have attached some FAQ to this report and have made some extra points surrounding expectations below:

- I always make my best attempts to be fully invested. While this is not always possible, I will aim not to hold cash. You can hold cash in your own bank account, why would you pay me to?
- The portfolio will be relatively concentrated, currently the top 5 holdings represent 52% of the portfolio. This is compared to the S&P 500 which is very diversified. We are not Kiwisaver or attempting to mirror the index. The aim is to outperform. Investors can therefore expect volatility swings in both directions that are in excess of the S&P.
- The portfolio will focus on stocks that are listed in the United States and Australia. Our broker, Interactive Brokers does not currently offer direct access to the NZX.

What I am looking for in an investor?

- A person or entity that meets the wholesale and eligible investor criteria.
- The investor who is focused on the long-term results and not day to day market fluctuations.
- Investors who are contributing a small fraction of their overall net worth to the portfolio.

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Frequently Asked Questions:

What is your Financial Service Providers Number?

Our FSP number is 531766

What does DCB stand for?

DCB stands for Dead Cat Bounce which is my favourite stock market acronym. This is a temporary recovery in a financial instrument after a substantial fall. I wanted to choose a company name that people would remember, I did not want to trade under the name because of the connotations with Dead Cats but I wanted an interesting story to tell when people ask what DCB stands for.

What service does DCB Investments offer?

DCB Investments offers a class discretionary investment management service to wholesale or eligible investors. This is the authority to buy and sell financial products on behalf of the investor in respect to a portfolio of investor.

What is a wholesale investor?

For original wording please refer to the Financial Markets Conduct Act 2013. Essentially your net assets will exceed NZ$5 million for the 2 most recent financial years, or the total turnover of you and the entities you control exceed NZ$5 million.

What is an eligible investor?

An eligible investor is a type of wholesale investor. An 'eligible investor' is a person who has sufficient knowledge and experience dealing in financial products that enables them to sufficiently assess the merits and risks of a transaction. To be an 'eligible investor' under the FMC Act a person must, before making an investment, certify in writing with certification from an independent lawyer, accountant or financial advisor that they are an eligible investor.

What are the goals of DCB Investments?

The goal of DCB Investments is to achieve the maximum return for investors while sufficiently minimising risk. The benchmark for return that we use is the S&P 500, over the long term we aim to outperform the S&P 500.

Where does DCB invest?

We largely invest in stocks that are listed in the US and Australian equity markets. On occasion where an opportunity presents itself we will invest in other international markets.

Why do we not invest on the NZX?

Our broker, Interactive Brokers, currently does not offer direct access to the NZX. We will from time to time invest in stocks that are New Zealand companies that also have a dual listing on the ASX. I believe that the current service offered is a point of difference among what is available to investors in New Zealand.

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What are the historical returns and what returns can I expect?

Future returns are impossible to predict. You will be able to track performance through your account management page online, you can access at any time. We also send monthly newsletters with performance update.

What is the minimum investment?

The minimum investment is NZ$25,000. This minimum is required because of diversification that we use for risk management. Smaller minimum investments will result in small positions sizes.

What happens to stock dividends?

When a company in the portfolio pays a dividend, it is paid in cash into the investors account. Dividends are then reinvested at the discretion of the manager. You can view any dividends through your account management portal.

What are the management fees?

All charges are automatically deducted by Interactive Brokers as per the management agreement between Dead Cat Bounce Limited and the client.

There are two types of fees: management fee & performance fee. The management fee (1% p.a.) is calculated daily based on the market value of your portfolio. Performance fees (10%) are calculated on a quarterly basis (to the second to last business day before quarter end) and deducted out of the profits at the end of each quarter. All fees can be viewed in your quarterly statements.

Who are Interactive Brokers?

Interactive Brokers (www.interactivebrokers.com) is a US based electronic brokerage firm. It is one of the largest brokerage firms in the world and has one of the highest investment grades.

Is the Account under my name?

Yes, your account is held under your name or preferred entity. DCB Investments has no direct access and cannot withdraw your funds. As per the client agreement we are only authorised to make investment decisions.

In what currency can I fund my account?

You can fund your account in most major currencies including NZD.

How can I withdraw funds?

We would prefer 4 to 6 weeks' notice before withdrawing funds. However, at the end of the day these are positions that are held in your account, so we are normally able to liquidate on request and Interactive Brokers are able to send the money back to you within a few days.

Is my money safe?

Your money is held with Interactive Brokers who are one of the largest and most secure brokers in the world. You can click here to view more information of the strength and security of Interactive Brokers.

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