MANAGER'S LETTER

Dear Shareholders,

We are excited about the coming decades and investment runway ahead. We are reminded of a quote by Jim Rogers: 'There are seven billion people in the world, there will always be opportunities'.

This is the key point and, we believe, attraction of Kaizen Global – we have the ability to allocate capital and invest anywhere in the world where we see the best opportunities. We don't have to invest in a company or country with poor prospects simply because it is included in an arbitrary index that we follow.

At present, many of the commodity-based economies are slowing and their currencies are adjusting downwards along with their stock markets. The Australian dollar (AUD), for example, has fallen from a peak of buying circa $1.10 US dollars (USD) for every Australian dollar to around $0.70 USD today. We believe that the Australian dollar could fall all the way back to buying only $0.50 USD (where it was when the commodity bull run of 2001/2 began) over a ten year period.

Remember that currencies don't move in straight lines up or down, and will zig and zag, but we believe that creates a tailwind to investing internationally. We believe that Australian savers are underinvested overseas and should use their Australian dollar, even at today's levels, to buy international assets. Please read our piece on the Australian dollar on KGI's website.

If you think that a fall to $0.50 is outside the realm of possibilities, you need only look at the currencies of the commodity based economies of Brazilian Real, Canadian dollar, South African Rand, Chilean Peso (Copper exporter) today to see how much these commodity currencies have already weakened – several are back to their 2001/2 lows already. The Australian dollar, at $0.70 US could still fall almost 30% from today's level if we are correct.

We have highlighted two positions in the portfolio today and our logic for owning them. They are at polar opposites in terms of size, but illustrate how diversified our investments are.

General Electric (GE) – Invest in ChΔnge: Thesis: Complex to simple

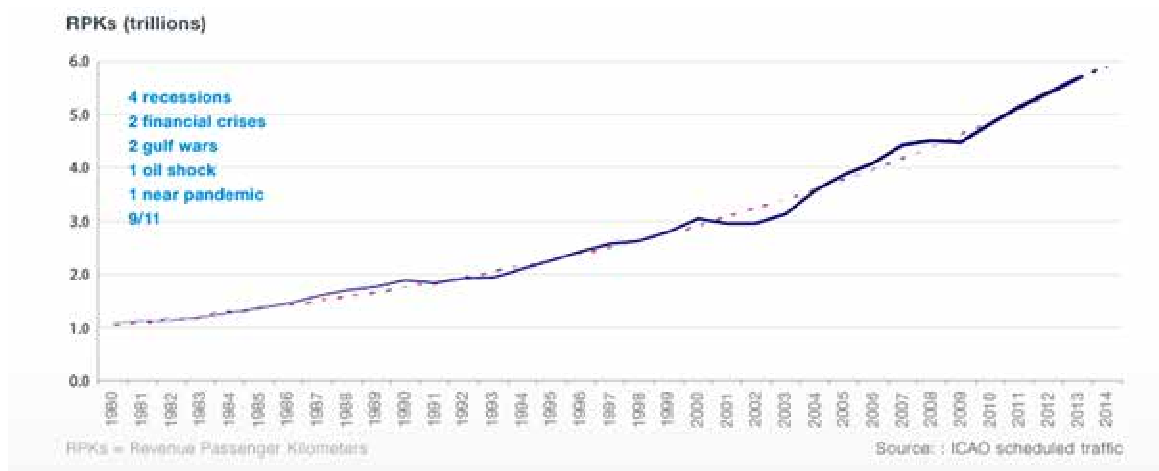
General Electric (GE) is one of our biggest investments. It is a very high quality company that we have followed for most of our career, but never invested in it due to its complexity. The diversified range of businesses from aviation and healthcare to financial services – to name but a few – required an investor to have a strong view and understanding on many moving pieces all at once. Inevitably there were a few end markets that you might not be as excited about, reducing interest in GE overall. But all that is chΔnging.

When Jeff Immelt, GE's Chief Executive Officer, took the helm in 2000 the stock price was in the $50 per share range. Today it is roughly half that. We believe that Mr Immelt, who will likely retire as CEO in the coming years, wants to leave a legacy that he can be proud of. The company has embarked on an enormous simplification that will see it shrink its financial service business (GE Capital) by $90 billion. The new GE will have +90% of its earnings coming from its industrial businesses. The capital that is being released from the financial services business will be redeployed into share buybacks (up to $50bn) and payment of dividends.

In the past, if you believed that global tourism will only grow into the future and that we'll need more planes, you might be very attracted to GE's aviation business, which has few competitors. Once the engines are combined with, say, Boeing's 787 Dreamliner, they will enjoy a service contract for decades, which can be very profitable for the engine maker. However, in investing in GE you would also gain exposure to the material consumer finance business of GE capital. So you might decide to invest in Rolls Royce instead, as a purer play on the investment theme.

In 2014 the aviation business made approximately 20% of GE's operating profit. In 2018 , with the sale of Capital, it could be closer to 30%. On the flipside, the capital finance business made approximately 30% of GE's operating profit in 2014 and we believe that could fall to approximately 5% by 2018 (but will be related to the industrial businesses). The shrinking of the financial services business will make investing in GE much easier if you were attracted to the aviation business – as we are.

AIR TRAVEL IS RESILIENT AND GROWING



GE has some exceptional businesses and is simplifying at an important time in the business cycle, in our view. Low interest rates and deep funding markets has created an environment where one should be a seller of large assets. We believe that GE will be able to sell these assets at good prices, quite quickly, and be able to redeploy the capital into buying back its stock. In a strange way, we should be rooting for a lower GE share price so that when the buyback commences, the company will be able to hoover up more cheap stock and cancel it, increasing earnings per share. Buffett has a good analogy for buybacks (at the right price) – you shrink the pizza base (share count), so that you get more cheese (profit) per slice of pizza (share). More profit/share could equal a much higher price per share, as investors pay up for the cheese.

We are also encouraged by the energy that the transformation seems to have released within the company. From our analysis, we believe that some of the current executive management are stepping up to the plate as the company repositions itself for the future. GE has some exceptional people working for it, and a refocussing on the industrial business could lead to improved results.

We invest with a 3-5 year horizon. So what could the new GE industrial look like then? The industrial businesses already command attractive returns on equity and capital with growing end markets, and we would hope that a new focus might bring more bolt-on acquisitions to the core business, enhancing profitability.

Margins of safety

We believe that the focus on the core industrial business will increase profitability and our earnings estimates per share are materially ahead of consensus estimates in 2018. What this means is that if we are too optimistic in our assessment of GE's potential and the actual results are in-line with consensus expectations, there should be no disappointment. However, if we are correct, then we have upgrades in earnings expectations to come, providing us with a valuation cushion since the shares are cheaper today than people think. In addition, the buyback is large and will represent a decent amount of demand for the shares in the coming year.

What could go wrong?

We are always mindful first of what could go wrong, before focusing on what could go right. As Stanley Druckenmiller says "Preservation of capital trumps home-runs". GE needs to execute and sell its financial assets before redeploying the capital to the buyback. GE, like many companies, is also exposed to global GDP and a slowing in world growth will impact them too. However, we believe that if it can quickly release capital from the financial services business, a downturn may create the opportunity to acquire bolt-on niche businesses in the industrial space. Weakness in the short-term may lead to strength in the long-term and we should be mindful not to jump at shadows.

The **key measurement of risk in any investment**, we believe, is the **permanent loss of capital**. We believe that in selling the financial services business, GE will be in an exceptionally strong position to capitalise on opportunities in the industrials business. We assess the risk of permanently losing capital with an investment in GE as very low, whilst the reward, if the company can execute as we believe, could be very high. Therefore the investment's risk to reward ratio is very attractive. As a result we have made GE a top 5 position in the Company.

Tower Financial: Invest in ChΔnge: A company transformed

Tower Financial (TWR) is a New Zealand based general insurer (home, contents and motor) with 140-year-old brand. It divested several business lines, medical insurance (2012), managed funds (2013) and life business (2013) to become a simplified insurer. On top of its New Zealand business it has a gem in its Pacific Island businesses – which we are excited about. Insurance isn't an easy sector to analyse, particularly in life businesses. Future liabilities are a long-way off and can be difficult to calculate even if you were the actuary working inside the firm. TWR however, has shed several business lines and is now much easier to understand. The simplification process occurred under the watch of David Hancock, the CEO until recently, who did an excellent job, in our opinion, of transforming the investment thesis.

General insurance is something we all buy and need. It is subject to short-term risks, like weather events, but importantly these tend to impact all industry players at the same time. When the whole industry suffers losses from an external event, they inevitably raise prices to claw back the losses in subsequent years. The risk is repriced and passed onto the consumer. A company with a trusted brand, good risk management and a strong balance sheet, should be able to make good returns over time, even if there are a few short-term hiccups along the way.

The company has two growth opportunities. First, industry consolidation in New Zealand is an opportunity to win market share. With circa 10% market share in its home and also contents business lines, TWR is big enough to have economies of scale, but small enough to grow a few percentage points relative to its larger peers (IAG/Lumley and Vero). Second, TWR has profitable operations and leadership in the Pacific Islands, which offers an opportunity for future growth.

TWR has a strong balance sheet and excess capital that is returning to shareholders.

In the company's May 2015 half-year results it highlighted that it had $51m of capital above its regulatory minimum and $48m at the Corporate level (after adjusting for dividends) – to have close to $100m of excess capital – which means it has about 27% of its market capitalisation in excess cash. This excess capital masks the profitability of the business, but if you stripped out the excess capital the ROE would be much better warranting a higher valuation.

We always try to look at each investment as though we were owners of the entire business. We would love to own Tower Financial in its entirety. The company currently pays out most of its earnings as a dividend (because it has excess cash) and that translates to a circa 7.7% yield at the time of writing. We believe the company can grow its profits and dividends in the years to come too, although there may be some years where profits are lower as weather events can result in claims reducing profits.

Margins of safety

The excess cash on Tower's balance sheet, which translates to circa $0.55 of a $2.06 share price, represents a significant margin of safety. It is worth noting that there has been consolidation in the New Zealand insurance market with the acquisition of Lumley by Insurance Australia Group Limited (IAG) in June 2014. Whilst we have not invested in TWR because we expect it to be acquired, it is worth considering what an acquirer might see through its eyes.

If an acquirer could purchase the entire company at today's share price it might be able to immediately redeploy the circa $100m of excess cash into the rest of its business – in effect, it would only pay $1.50-$1.60 for the core operating business.

There would likely be savings too in running the Tower brand across a wider distribution platform, further increasing returns. One area of particular interest to us, would be the savings associated with buying reinsurance, since a very large insurer would have economies of scale and buying power versus Tower today. We like to quantify what upside there could be when we analyse various investment scenarios, and whilst we have no insight into whether TWR could be acquired, on paper it makes a lot of sense to us. Critically, we are not paying for that optionality in the share price today, we own a share in a business with a strong brand, that pays a 7-8% dividend yield that can grow. The company is redeploying its excess capital to shrink the share count through a buyback, which will enhance return on equity, earnings per share and dividend per share growth. There are weather related risks which will always be unknown until they arrive, but the long-term nature of insurance is to increase premiums in the years after big storms to recover losses.

Outlook

The equity bull market that began in March 2009 is now over six years old, which is quite long in the tooth if you look at history. We are mindful of this, and have some defensive investments, but are also still finding attractive investments.

Markets have ups and downs, that is how they work, but in the long-term they rise. If we were to enter a bear market today we believe that the Company is well positioned to take advantage of the opportunities that low prices will bring over the coming years since we invest with a medium to long term horizon.

One mistake that investors sometimes make is to second guess their portfolio manager. In a period of gloom and doom one might be tempted to sell. However, an active manager with a long-term horizon may be repositioning the portfolio in the gloom and buying great businesses for a song (since everyone is selling). That might be the very time to add capital to managers that really have a long-term outlook (and there aren't many in our opinion). We believe that active fund managers are often very defensively positioned at the bottom of stock markets (they own food companies, pharmaceuticals, tobacco and utilities for example) and are obsessed with monthly performance relative to their index. This means that other sectors, that will be experiencing tough trading conditions, will be under-owned and possibly very cheap. We would likely be investing against the tide and therefore bear markets, for us, are great opportunities.

We look forward to working hard to growing all shareholder's capital in KGI in the decades ahead.

Yours sincerely,

Connor Grindlay
Portfolio Manager
15 September 2015