January 12, 2015

To Our Partners,

It is our privilege to present the 2014/15 Harrington Partners Fund 1 (HPF1) interim letter. Included within this letter is a summary of performance over the period, a discussion on what we believe are the inherent competitive advantages of HPF1, and a detailed description of a proposed change to the current fee structure. Please take the time to carefully read through the letter in its entirety whilst paying particular attention to the proposed changes to the fee structure.

Performance Summary

Before taking into account fees and charges the unit price for HPF1 finished 2014 at **$1.0607**. This equates to a return for the fund of **2.77%** over the first 6 months of financial year 2015. Although we do not try to match any index or benchmark we feel it is necessary to test our performance against an ongoing reference point. For this purpose we believe the All Ordinaries Accumulation Index (AOAI) is suitable given it provides a good comparison to what an investor could achieve in a low cost broad based index fund. Over the past 6 months an investment in the AOAI would have returned 2.28%. Since inception the Fund has returned **6.16%**, this compares to a return for the AOAI of 4.70% over the same period.

Date	HPF1 Gross Return	HPF1 Net* Return	Distribution	AOAI Return
1/01/2014	-			
30/06/2014	**4.01%**	**3.71%**	**$0.00494**	**2.36%**
31/12/2014	**2.77%**	**2.36%**	**-**	**2.28%**
Overall Gain Since Inception	**6.89%**	**6.16%**	**$0.00494**	**4.70%**

Data source for AOAI Returns: S&P Dow Jones Indices LLC. *Net Return to investors which is less fees and charges but includes distributions

We would like to note that the absolute returns for the Fund have been below what we set out to achieve on an annualised basis. However a 12 month period is not a sufficient amount of time to gain any comparable insight into the performance of any long term investment vehicle, this should be done over at least a 3-5 year period.

Throughout 2014 we followed our core investment principle of allocating capital only when it is prudent to do so. Our first preference is to pay sensible prices for well managed businesses that have stable cash flows, conservative balance sheets, and the ability to grow their franchise. Unfortunately for the majority of the year we were unable to build meaningful positions in businesses that met these criteria, however we were able to deploy capital within pockets of the market that provided deep value opportunities. The portfolio's exposure to equities at year end is lower than we would have preferred, and although we intend to maintain a relatively high cash balance at all times, our current position is greater than we expected. This scenario has also been accentuated by the fact that the

investable capital of the Fund has grown progressively over the past 12 months, from a small base and at a faster rate than we have been able to deploy it.

Some of the portfolio holdings have experienced price declines since purchase (which is to be expected) and in some cases we have taken advantage to increase the Fund's ownership at an even greater discount. The market is inherently unpredictable and we do not presume to know how low any particular share price may go, however this does not deter us from accumulating an ownership in business's when we can do so at prices we feel represent significant discount to intrinsic value. Here we follow the direction of Benjamin Graham when he said:

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."[1]

Fortunately the volatility in recent months has resulted in certain pockets of the market shifting to a much more rational pricing environment. As a result we are finding that many more potential investments are coming within, or very close to, our appraisal of intrinsic value and believe this year, as always, will present a number fantastic opportunities for those who are prepared.

HPF1 Competitive Advantage

When we analyse investments one of the most crucial elements we look for, amongst others, is a competitive advantage. More specifically, characteristics inherent in the business that will allow it to generate *above average* returns on capital over the long term. Without a competitive advantage the best a business can hope for is to earn *average* returns on capital over the long term. HPF1 is a business. Its objective is to compound owner's capital at above average rates over the long term. Therefore it is imperative that HPF1 also possess a legitimate competitive advantage in order for it to be able to achieve its objectives.

HPF1 has a competitive strategy focused on exploiting opportunities that, for one reason or another, the majority of our competitors are unable or unwilling to use to their advantage. We are afforded structural advantages due to the omission of common impediments to the average institutional money management firm, namely:

- Strict asset allocation mandates;
- Market capitalisation/sector restrictions;
- Modern portfolio theory;
- Benchmark reporting;
- Daily asset pricing;
- Lack of proprietary 'skin in the game', and;
- Redemptions in real time.

We believe the absence of these impediments gives us the best opportunity to practice a more logical method of long term wealth creation through securities investment and avoid the short term herd mentality that has the potential to be so destructive.

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1. *Graham, Benjamin, 'The Intelligent Investor Revised Edition 2006', pg 477*

Structural Advantage

Our flexibility in asset allocation means we do not carry the burden of a pre-determined aggregate portfolio construction and therefore can take advantage of the markets unpredictability as opposed to becoming a victim of it. Likewise, we are unable to see the benefit of excess diversification to the enterprising investor, our objective is to allocate significant proportions of the Fund to our best investments. The opportunity to acquire truly great investments at reasonable prices is rare, as such when it occurs we take positions that are meaningful to HPF1. It would be a disadvantage for us not to decisively back such convictions, as this is what makes the bulk of our time spent searching for such opportunities worthwhile.

We do not heed relative benchmark performance and are unconcerned with portfolio volatility which may lead to fluctuations in the Fund unit price over weekly, monthly and even yearly timeframes. Rather, our attention is squarely focused on the intrinsic value of the portfolio and the long term competitive strength of our underlying investments. Managers have a habit of managing to how they are measured and this is why we never intend to report the unit price more often than semi-annually. It is our intention to be measured against our pledge to *protect our partner's capital against diminution in real terms whilst delivering above average absolute returns over a three to five year period*. This mandate and measurement criteria allows us to clearly articulate our day to day focus and to find investments which minimise downside risk and provide adequate return potential to compensate for the risk assumed.

All of the above characteristics of HPF1 are important however our biggest advantage by far is the patient capital commitment of all partners. HPF1, now and in the future, seeks to operate under the mutual recognition between partners that effective wealth creation is a steady cumulative process that takes many years. The restriction on redemptions reiterates this and is designed to encourage all partners to view their investment in the Fund in its true form – as a part ownership in a business. This helps to create an alignment between the capital allocation philosophy of the Fund's management team and the Fund's owners. The power of this long term capital commitment should not be underestimated because it acts as a support to management's decision making process. As managers we have the ability to make decisions with the knowledge that the bulk of the investable capital base is unlikely to be called upon before the underlying investments have had time to manifest their appraised value. This helps to elevate our line of sight above and beyond the near term fog of market hysteria into a more appropriate investment horizon, and ultimately take advantage of the short term bias of the market.

The final structural advantage is the alignment of incentives between us as managing partners and you as capital partners which is formed by our large relative ownership in the Fund. We both have the overwhelming majority of our net worth in the Fund; we cannot guarantee our stated objectives will transpire, but we can guarantee that we will approach every decision as prudently as an owner who personally bears the outcomes of their actions.

While each of these structural advantages is important in its own right, the biggest advantage accrues when they are combined with a superior intellectual framework centred on achieving long term investment success.

Intellectual Framework

In order to achieve our goal of generating above average returns over time we have to think and act *differently* from the market, this is the ethos of a contrarian approach. However being contrarian, ipso facto, only works if an investor is contrarian and *right*; being contrarian and *wrong* causes permanent loss of capital. Therefore, to be successful, an investor must think and act *better* than the majority of market participants and this requires independence and clarity of thought. For this reason we pro-actively attempt to remove ourselves from the inevitable fashion, fear and greed that drive investor mentality because we think this allows a more rational interpretation of information and ultimately leads to better analysis. Once again we seek to follow sound advice from proven sources:

> *"To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework." Warren Buffett*[2]

We do not pretend to have above average IQs, business insights, or inside information. We do however believe that we have an inherent mentality which adds value to the long term investment process, in addition to operating with a structure (as outlined above) that minimises corrosion of this mentality.

At its core this mentality rests on an unwavering belief that a concentrated portfolio built on a fundamentally focused bottom up value investing approach, delivers superior long term investment returns. We use a research driven model which focuses on straightforward investment ideas where we can understand the downside risk and conservatively establish the intrinsic worth of an investment. This then becomes our reference point for value whilst the market provides the price. We buy only when we can realise a price sufficiently below appraised intrinsic value and this discount to appraised value is what we refer to as our 'margin of safety'. In this pursuit price volatility is our ally not our foe as it provides opportunities to buy assets at below their intrinsic value. We do not consider volatility in the market price to be representative of a particular investments 'risk' because permanent loss of capital and insufficient returns to maintain relative purchasing power are our ultimate measures of risk. We have no control over the market price but we do have the ability to be patient and wait until it brings us, as it ultimately will, low-risk high-return investment opportunities.

Despite this, we cannot definitively determine when our appraised value will be realised because consistently doing the right thing at the right time is extremely difficult. Therefore we do not attempt to time the market, we certainly look for catalysts and pay heed to the opportunity cost of capital, but primarily we buy securities which we think are undervalued without any absolute insight as to when intrinsic value will materialise. It is a given that in some cases securities will decline in price after we have purchased, however we see this as a benefit because it enables us to increase our ownership in high probability outcomes at cheaper prices.

***2.** Buffett, Warren, 1973, 'The Intelligent Investor', Preface to the Fourth Edition, p. ix.*

Over the long term we have full faith the markets will recognise the intrinsic value of these investments and this will deliver significant upside for owners who bought at much lower prices. Having a steadfast commitment to your rational intrinsic valuation, regardless of the market noise, is the essential foundation for steady, unemotional, and ultimately profitable investing.

Overall we believe this method, although only briefly described, is the most logical way to build wealth and more importantly it has been proven over very long periods. We do not contend that this philosophy is the only way to create wealth in the share market, but it is the only way in which we are comfortable investing our own money and is therefore the only way we will invest yours.

Revised Fee Structure

It has become clear to us after running the fund over the past 12 months that our current fee structure can be improved. We feel that it is not ideal for all partners and creates an unintended misalignment between fees and our investment philosophy. As a result we are proposing to implement a revised fee structure by resolution at a meeting of members, the details of which are outlined below along with a Notice of Meeting, Explanatory Memorandum and Voting Form attached herein. If the resolution is passed it is our intention to implement the amended fee structure immediately following the meeting. Please take time to carefully read through the remainder of this letter; specifically the hypothetical fee structure table, our rationale for the change and also the attached meeting related documents.

The proposal seeks to amend the Constitution by removing all Management Fees and reducing the Benchmark Return hurdle (over which Performance Fees become payable) from in excess of 10% per annum (p.a.), to in excess of 6% p.a. The buy/sell spread and the expense recovery fee (for ordinary expenses only) remain unchanged. If the resolution is passed, the Performance Fee payable will become 25% + GST of the amount by which the Fund's performance exceeds 6% p.a., the necessity to exceed the High Water Mark remains unchanged. Please refer to the table below for a detailed illustration of how the new fee structure compares to the current fee structure when based on a hypothetical $100,000 investment under different annual return scenarios.

Current Fee Structure

Investment Return on $100,000 investment.

Total Fund Return per annum	-5%	0%	6%	7%	8%	9%	10%	15%	20%
Total Fund Return $	-$ 5,000	$ -	$ 6,000	$ 7,000	$ 8,000	$ 9,000	$ 10,000	$ 15,000	$ 20,000
Management Cost (0.75% + GST)	0.825%	0.825%	0.825%	0.825%	0.825%	0.825%	0.825%	0.825%	0.825%
Expense Recovery Cost (0.1% + GST)	0.11%	0.11%	0.11%	0.11%	0.11%	0.11%	0.11%	0.11%	0.11%
Performance Fees (25% + GST of returns above 10%)	NIL	NIL	NIL	NIL	NIL	NIL	0.00%	1.38%	2.75%
Total Fees Paid	$ 935	$ 935	$ 935	$ 935	$ 935	$ 935	$ 935	$ 2,310	$ 3,685
Net Investment Return	**-5.935%**	**-0.935%**	**5.065%**	**6.065%**	**7.065%**	**8.065%**	**9.065%**	**12.690%**	**16.315%**

Revised Fee Structure

Investment Return on $100,000 investment.

Total Fund Return per annum	-5%	0%	6%	7%	8%	9%	10%	15%	20%
Total Fund Return $	-$ 5,000	$ -	$ 6,000	$ 7,000	$ 8,000	$ 9,000	$ 10,000	$ 15,000	$ 20,000
Management Cost (NA)	-	-	-	-	-	-	-	-	-
Expense Recovery Cost (0.1% +GST)	0.11%	0.11%	0.11%	0.11%	0.11%	0.11%	0.11%	0.11%	0.11%
Performance Fees (25% + GST of returns above 6%)	NIL	NIL	NIL	0.28%	0.55%	0.83%	1.10%	2.48%	3.85%
Total Fees Paid	$ 110	$ 110	$ 110	$ 385	$ 660	$ 935	$ 1,210	$ 2,585	$ 3,960
Net Investment Return	**-5.110%**	**-0.110%**	**5.890%**	**6.615%**	**7.340%**	**8.065%**	**8.790%**	**12.415%**	**16.040%**

Difference in net investment returns on total investment compared to previous fee structure	0.825%	0.825%	0.825%	0.550%	0.275%	0.000%	-0.275%	-0.275%	-0.275%

As illustrated in the table above, the main differences between the new and the old fee structure occur when the overall Fund returns are between 6% p.a. and 10% p.a. More specifically, under the new structure:

- When returns are 6% p.a. or below, fees payable on partner's total investment will be 0.825% lower. This occurs because the 0.825% Management Fee will no longer be payable.

- At 9% p.a. fees payable will be the equal to that under old structure.

- When returns are 10% p.a. or above fees payable on partner's total investment will be 0.275% higher. This occurs because the Performance Fee Hurdle is lower.

- The potential for higher fees is capped at 0.275% of total investment and only occurs if returns are in excess of 10% p.a.

Rationale behind Revised Fee Structure

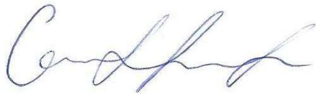
As discussed, protection of capital and long term above average performance are the cornerstones of our investment objective. To achieve this we have to make sure that we only invest in the most compelling opportunities available. We have made the commitment to all partners that we will not dilute our investment standards when a dearth of such investment opportunities prevails. As a result the Fund could likely hold relatively large cash balances at any given time. HPF1 will always maintain a minimum cash holding but we do not have a maximum. If we cannot deploy it in worthwhile investments, it will be deployed in a cash account. Although we believe this is the most prudent way to manage an investment operation (given the significant option value of cash when fear grips the market), we do not believe we should be getting paid for something every investor is perfectly capable of doing themselves.

We ask you to commit your capital to HPF1 for a minimum of 3-5 years and allow us to build mutual wealth in the best way we know how. We also ask to be paid, and paid well, but only when we perform and not for the privilege of holding assets. Trust and alignment of interests between business partners is critical and as managers we seek to conduct ourselves whereby we would be happy if the roles were reversed. We believe the best way to achieve this is by implementing a fairer remuneration structure which should also encourage all partners to adhere to the HPF1 philosophy. From our perspective the change to the fee structure strengthens both the alignment of interests and the commitment to the HPF1 philosophy.

Changing the fee structure is not something we take lightly, but after careful consideration and much discussion we think it is an important change to make. We feel more comfortable charging fees in this way and, as significant unit holders ourselves, we think the new remuneration structure more closely aligns the interests of the investment manager and partners. However, we respect the fact that other partners may have differing perspectives and we are open to any input you have on the proposition. If you would like to discuss any matters further please do not hesitate to contact us.

In closing we would like to wish you all a happy, safe and prosperous 2015. We thank you for your partnership and look forward to reporting the HPF1 2014/15 full year results in due course.

Yours Sincerely,



Cameron Harrington
Managing Director
Harrington Partners Pty Ltd
Email cameron@harringtonpartners.net.au

Brendan Harrington
Managing Director
Harrington Partners Pty Ltd
Email brendan@harringtonpartners.net.au

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