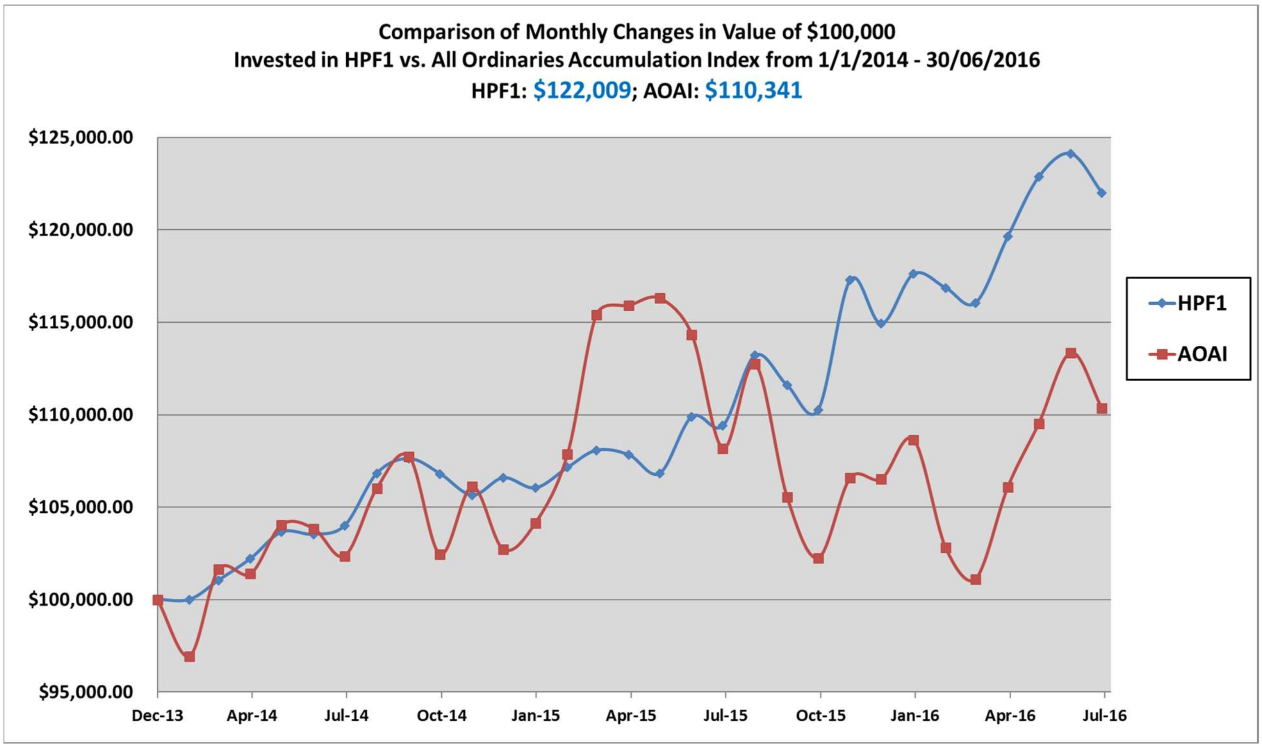
10 August 2016

Dear Partners,

The unit price for Harrington Partners Fund 1 (HPF1, the Fund) finished the financial year 2016 at **$1.2166**, equating to a return of **13.48%** over the period, before taking into account fees and charges. The Fund does not try to match any index or benchmark, however, it is necessary to test performance against a pre-determined and relevant reference point. For this purpose, the All Ordinaries Accumulation Index (AOAI) is suitable given it includes reinvested dividends and provides a sound comparison to what an investor could achieve in a low-cost broad-based index fund. Over the past 12 months an investment in the AOAI would have returned 2.01%. With distributions reinvested and net of all fees, HPF1 has returned **22.01%** since inception, this compares to a return for the AOAI of 10.34% over the same period.

	HPF1 Net* Return	Distribution Per Unit	AOAI Return#	Relative Performance
6 Months to 30/06/2014	**3.71%**	**$0.00494**	**2.36%**	**1.35%**
30/06/2015	**5.51%**	**$0.01693**	**5.67%**	**-0.16%**
30/06/2016	**11.50%**	**$0.09448**	**2.01%**	**9.49%**
Annual Compounded Rate	**8.28%**		**4.01%**	
Cumulative Performance	**22.01%**	**$0.11635**	**10.34%**	**11.67%**

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



The Harrington Partners Approach

Harrington Partners' primary objective is to protect partners' capital whilst achieving performance that is superior to the market average over the medium to long term. We are patient value orientated investors with a fundamental approach that is thorough, creative and flexible. Our investment universe is not pre-determined by size, industry, or geography, providing us with the ability to operate in areas that are out of favour or not as widely researched by the broader investment community.

We do not follow any rigid formulas or complex rules and avoid the need for overly optimistic long term predictions, complex financial products, or elaborate modeling. We do not trade price movement, trends, or macro-economic theories.

Our process has a core emphasis on minimising error. We proactively work to mitigate the possible impacts of psychological and cognitive biases on our decision making and have intentionally built an operating structure that supports this.

We see ourselves as business owners and although the bulk of what we do is numbers driven, we focus intently on both the tangible and intangible qualitative elements which are necessary for a successful investment. We view the management teams of the businesses in which we invest as our partners and therefore demand high levels of integrity, skill and alignment with shareholder interests.

Our first preference is to pay sensible prices for well managed businesses that are conservatively financed, possess durable competitive advantages and have the ability to grow their franchise over time. Opportunities to buy these businesses at prices below our appraised intrinsic value are rare. When we do find opportunities that meet these criteria, we are willing to own them indefinitely, providing the fundamental investment hypothesis remains sound.

If our first preference cannot be met, we are confident to scour the market in search of situations where the probabilities of achieving superior returns are in our favour.

Resources are concentrated on our best investment ideas; this has the potential to lead to volatility relative to the market average. We do not consider this type of volatility to be a relevant measure of risk for the long term investor. Rather, our primary determinant of risk is the probability of permanent loss of capital. Ultimately, if we are unable to find opportunities that meet our investment criteria, then we hold cash.

Our goal is to establish mutually beneficial long term relationships with partners who align with this philosophy and appreciate that meaningful wealth creation requires time and persistence. Achieving our economic objectives is crucial to HPF1s enduring success, however, building a business that all partners are proud to be part of, and appreciating the journey, are equally important.

We only get paid for positive performance and all of our investable net worth is in the Fund, this ensures a strong alignment of interests with partners. Investing is our passion and we continually strive for improvement, both professionally and personally.

Key Portfolio Statistics as at 30 June 2016

Portfolio Weighted Average Market Capitalisation*	**$55million**
Number of companies	**17**
Australian Shares	**40%**
International Shares	**1%**
Cash	**59%**
Concentration of top 5 holdings	**23%**

*Does not include 0.5% portfolio holding in very large market cap company which skews the overall average to $235mil.

The above table illustrates various key portfolio statistics as at 30 June 2016. The average weighted market capitalisation of the portfolio is relatively small at $55m, which is a product of our current predominate focus on the smaller less researched businesses within the market. The Fund currently owns shares in 17 companies with 41% of the total portfolio invested in equities and the remainder in cash. Our top 5 equity positions account for 23% of the total portfolio or 56% of total equities exposure.

The Fund recently sold its largest position which accounted for around 15% of the portfolio and this contributed to the year-end cash balance. Clearly the cash position is not optimal and we are, as you would expect, working diligently to identify suitable opportunities in which to invest. That said, we are not letting this state of affairs lull us into diluting our investment discipline. Sitting on your hands when you cannot find suitable investment opportunities is just as important to long term success as swinging for the fences when the probabilities are in your favour.

Over time, we expect to have 80-90% of the Fund invested in 15-25 businesses with 50%-60% in our top 5 investment ideas whilst always maintaining a sufficient amount of cash to remain opportunistic. Ideally, we would be confident to only own around 15 businesses, however the dynamic nature of the stock market generally results in the accumulation of a number of small positions (<2% of portfolio) as we are not always able to build our ideal levels of exposure within each idea at favorable prices.

Our Goal

Harrington Partners goal is to protect partners' capital and achieve long term investment performance, net of fees, superior to that of the market average. It is our wish to be judged on this performance over a minimum 5-year period, preferably with tests of relative performance in both strong and weak markets. If we do not achieve this goal, then there is no reason for the existence of the Fund. Although we believe this is already well understood by all partners, it is necessary to be more specific about this goal and how we envisage a long term investment in HPF1 will unfold.

Determining whether performance is indeed superior requires us to make an objective comparison against a predetermined and relevant investment alternative. As stated above, we have elected to use the All Ordinaries Accumulation Index (AOAI) for this purpose. The performance of the AOAI consists of the capital appreciation and dividends generated by the top 500 company's listed on the Australian Stock Exchange. The AOAI provides a relevant and fair proxy against which to test HPF1 performance over time as investors can gain exposure to the index through a low cost index fund.

We do not try to predict the future returns of the AOAI but simply expect that the future will look somewhat like the past. **Our specific goal is to outperform the AOAI by 3-5% annually as measured over rolling 5-year periods.** If achieved, the compound annualised value of this superior performance will have a significant impact on the investment returns of all long term partners. That said, it is important to understand our following expectations in regards to the characteristics of this performance over time:

1. Superior performance is likely to be achieved ***not*** through beating the AOAI by a consistent margin on a year-to-year basis, but rather, through generating above average performance in stable or declining markets while accepting average or potentially below average returns in sharply rising markets. Indeed, during a year in which the price level of the AOAI appreciates significantly, we will be satisfied just to keep pace. For example, we would consider a year in which the Fund declines 20% whilst the AOAI declines 35% to be a far superior outcome than a year in which both the AOAI and the Fund advances 15%.

2. We expect superior absolute long term returns to be achieved through enduring both positive and negative return years. The Fund primarily invests in listed equities and we have absolutely no control over market prices which can be extremely volatile over short periods. In addition, it is likely that our concentrated portfolio approach may lead to higher volatility relative to the broader market.

3. Whilst we agree with the rationale for the relative long term performance test outlined above, we do not think about our day to day actions in terms of *relative* performance. Rather, our goal at any point in time is to protect our partner's capital from *absolute* diminution whilst achieving the highest possible *absolute* return on this capital. We rate our performance against the AOAI on 5-year rolling basis as a means to objectively determine whether our approach is adding value for partners. Importantly, the HPF1 incentive structure supports this approach, with the two key elements being; **a)** we are only paid for absolute positive performance, and; **b)** we have all our investable wealth within the Fund.

Concentrated Investing

The experience of the last 2.5 years has strengthened our belief that owning a prudently concentrated portfolio of businesses, in which we thoroughly understand the intrinsic value, is one of the most important characteristics necessary for HPF1 to achieve its objectives. The Funds' performance since inception has been generated from a portfolio that, on average, owned around 16 businesses and held approximately 50% in cash. The bulk of the positive performance was generated by 5 businesses with the largest contributors being investments where, on a relative basis, our conviction on intrinsic value has been the strongest and portfolio allocations the highest.

We believe that we have not yet fully leveraged the benefits of concentrating our time, energy and capital to anywhere near its potential and we know we can significantly improve in this area.

Going forward, we intend to make fewer, but better, investment decisions, thereby creating the necessary time to be able to allocate a greater proportion of our resources into our highest conviction investment opportunities. Ideally, HPF1 will have 50%-60% of the portfolio invested in our top 5 positions. This is likely to result in the portfolio having little correlation to the AOAI because our largest portfolio holdings will have a much greater proportionate effect on overall performance than is the case under broad diversification. We do not view being differentiated from the AOAI as a source of ‘risk’ for the enterprising investor, rather we think it is prudent and indeed **necessary** to achieve **superior** long term performance.

Building a prudently concentrated portfolio generally takes a lot of time as each opportunity needs to be thoroughly understood before we can reach the level of conviction necessary to build a large ownership position within the Fund. Fortunately, once such a portfolio is established, one or two sound opportunities each year should be sufficient for us to achieve our long term goals. Having a patient and persistent focus on quality over quantity, in combination with the broader HPF1 approach, is fundamental to achieving our stated performance expectations.

Business Discussion

Although we have previously detailed some specific portfolio holdings in this section we now think it best that future investment operations not be discussed until such time as they are ‘complete’. A complete investment operation will *generally* be that of; **a)** a long term holding in which we have acquired our desired portfolio position, and **b)** a medium term holding that has been acquired and subsequently sold. This change in approach is designed to minimise the potential of us becoming overly committed to any publicly discussed positions thereby giving ourselves the best chance of remaining as objective as possible at all times.

The Fund significantly reduced its holding in **Service Stream Limited [ASX: SSM]** as we felt that the value received upon sale sufficiently compensated us for our appraisal of intrinsic value. The business is exceptionally well managed and this has been a significant contributing factor to its financial performance exceeding our expectations. We were very pleased with the board’s recent decision to make a capital return to shareholders in a form which was even better than we ourselves advocated for. Regardless, we could not identify any sustainable competitive advantages necessary for a suitable long term investment and were therefore happy to sell for what we believe to be a reasonable price.

The financial contribution from SSM has been very favourable for the Fund with a return of around 2.4 times our initial capital in a little over 18 months. Perhaps more importantly, is that the overall experience provides a good case study for how the HPF1 approach can add meaningful value over time. With the benefit of hindsight, it is relatively clear to see that there was undue pessimism and perceived complexity surrounding SSM which created a very favourable opportunity for longer term investors. Fortunately, our philosophy, process and structure allowed us to take advantage of that opportunity whereby we could patiently let the value of thorough fundamental research accrue over time. We will continue to track both the business & the industry as a means to leverage and expand our accumulated knowledge in preparation for similar opportunities in the future.

The majority of the 6 businesses remaining in the **mining services ‘basket’** continue to deliver improved operating performance and we have invested a small amount of additional capital in those where the value continues to be compelling. This basket approach involves holding a larger number of smaller investment positions which together require a significant amount of time and effort to competently manage. Thus far, the portfolio contribution from this group has been sufficiently positive but the jury is still out on whether such a ‘basket’ strategy, wherever it may be applied, is worthy of our resources in the future. We believe the aggregate result from the current operation will prove satisfactory and, as so often is the case, patience remains the order of the day.

During the period we decided to sell half of our position in **RNY Property trust [ASX: RNY]** at a 50% loss after the release of their full year results in late February made it clear that our initial investment was a mistake. Our hypothesis primarily rested on the expectation that demand for the suburban office properties owned by RNY would increase as the US economy improved and unemployment fell, leading to higher cash generation and an increase in property values. However, our prediction was incorrect and it is now clear that there has been a structural shift in the demand profile for suburban office property broadly. This shift is being driven by the fact that employers are having to relocate and adapt their work spaces to attract the next generation of younger workers. These employees prefer to both live and work in inner city locations where 'the action is', with improved access to cafes, restaurants, bars, public transport, etc. Unfortunately, RNYs properties are located in relatively distant suburban areas where social and public amenities are limited and this has resulted in significantly lower expectations for longer term occupancy rates.

Management cited the above structural changes as central to their rationale for writing down the groups assets by 15% which caused their debt to equity ratio to increase from 65% to 75% and Net Tangible Asset (NTA) per unit to decrease from AUD$0.60 to AUD$0.35.

The results also outlined a revised strategy whereby the focus will now be on *"…selling down the assets in an orderly, strategic manner over the next 12-24 months",* as opposed to a more extended period of liquidation as we expected. The Fund still owns half of its original position as we believe the intrinsic value remains above the current market price, however, we are very cognisant of RNYs heightened leverage risks and the potential difficulties of executing their updated strategy.

This experience highlights the importance of thoroughly understanding the true market worth of assets on which your investment hypothesis heavily relies, especially when they are supported by a significant amount of debt. Whilst the value of these assets can change, the value of the liability attached to the assets generally persists. As RNY illustrates, a 15% asset write down, led to a disproportionate 42% evaporation in equity value due to their leverage.

This experience has taught us valuable lessons about evaluating operational and financial leverage, the risks of asset devaluation, and ultimately, not demanding a high enough margin of safety. Our relatively low portfolio allocation has so far limited the effect of this mistake.

Psychological and Cognitive Biases

We believe that our focus on minimising errors instead of trying to consistently 'hit the ball out of the park' will be a key contributor to the long term success of the Fund. One of the primary ways we seek to reduce mistakes is through mitigating our innate vulnerability to potentially detrimental psychological and cognitive biases. We try to guard against these biases through systematically testing the objectiveness and rationality of our thinking processes before making highly consequential decisions. This is a constant, time consuming and necessary learning process to which we are committed. We consider the late American physicist Richard Feynman summed up the concept very appropriately when he said;

"The first principle is that you must not fool yourself and you are the easiest person to fool"

Below we have outlined three key biases, amongst many more, that can lead to poor decision making and undesirable investment outcomes.

1. Anchoring Bias
In his seminal book *"Thinking Fast and Slow"*, American psychologist Daniel Kahnemann stated that; *"Any number that you are asked to consider as a possible solution to an estimation problem will induce an anchoring effect".*

One of the areas in which investors are most susceptible to the detrimental effects of anchoring bias is when they are exposed to current and past market prices of a business. For example, there is a tendency to jump to conclusions that a stock may be 'cheap' because it has fallen well below its previous trading history or 'expensive' if it is risen well above it. However, this relationship provides absolutely no reliable information as to the underlying intrinsic value of the business which is the only characteristic on which we can confidently determine whether it is indeed cheap or expensive relative to the current market price.

Although it is quite hard to do, we attempt to reduce this detrimental influence through minimising our exposure to a business's share price until such time as we have determined our intrinsic value. We also avoid letting the market price be an overly influential factor in our decision on whether or not to allocate resources to researching potential new investment opportunities. Instead, we try to be prepared for opportunities through maintaining an up to date inventory of suitable investments so we can act decisively during periods of market volatility.

2. Confirmation Bias

Confirmation bias is a natural human tendency to seek out or emphasise information that supports or is confirmatory to your existing beliefs. It is extremely dangerous in the discipline of investing because it can lead to overconfidence and hubristic behaviour which greatly increases the likelihood of costly mistakes. The best way to combat confirmation bias is to continually challenge your ideas and tightly held beliefs by objectively comparing them against the merits of different or opposing views. This is an intensely active and sometimes painful process where you have to be humble enough to admit you may be wrong and to change your mind when the facts warrant such an action.

We aim to minimise our reliance on subjective assumptions through constantly seeking out and objectively weighing reliable evidence that challenges our reasoning and point of view. This is a fluid process which requires interpretation of facts and resultant reasoning to be continually tested to avoid incorrect or misguided decisions. It is extremely important that we always consider the relevance of disconfirming evidence as it comes to hand and impartially revaluate any investment. We consider Charlie Munger, Vice Chairman of Berkshire Hathaway, provided profound insight on how well this framework needs to be developed when he stated that:

> *"The ability to destroy your ideas rapidly instead of slowly when the occasion is right is one of the most valuable things. You have to work hard on it. Ask yourself what are the arguments on the other side. It's bad to have an opinion you're proud of if you can't state the arguments for the other side better than your opponents. This is a great mental discipline."*

3. Commitment and Consistency Bias

As outlined above, having an eagerness to challenge your own strongly held beliefs is a vitally important characteristic of long term investment success.

This can be extremely hard to achieve as people have an innate personal and social desire to be known as committed and consistent to their previously established positions. In many situations, being committed and consistent is the correct approach as it can mean you are considered a more reliable person whose word can be trusted. However, it can become dangerous when applied as the default response to *all* situations.

When investing, being overly committed to a previously held position can lull an investor into unnecessary subjectiveness as they try to protect their point of view and avoid being seen as indecisive. This can be especially dangerous when a position is publically stated because there is a strong likelihood of remaining stubborn when others have observed and are likely to judge these actions. The detrimental influences of commitment and consistency bias, along with confirmation bias, are some of the main reasons why we avoid talking publically about our current and potential investments.

Internally we seek to minimise these biases through objectively updating our perspectives when reliable evidence comes to our attention, whether this be contrary or supportive to our prior beliefs.

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We are extremely grateful for your continued support, especially during these early years and would like to wish you and your loved ones a happy, healthy and prosperous financial year 2017.

Be sure to contact us if you have any questions or comments

Yours Sincerely,

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