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**Dear Investor**,

**Words from the great one.**

Its that time of year again when we get to read Warren Buffett's annual letter to shareholders. I can provide no greater investment advice to anyone than to read Warrens annual letter. **http://berkshirehathaway.com/2017ar/2017ar.pdf**

**"Investing is an activity in which consumption today is foregone in an attempt to allow greater consumption at a later date. "Risk" is the possibility that this objective won't be attained."**

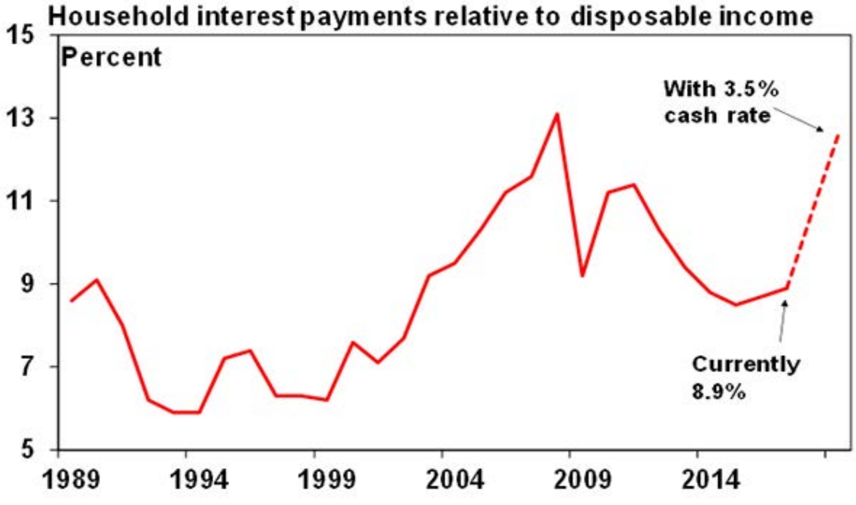
**Warren Buffet from 2017 annual letter to investors**

**Australian's addiction to debt.**

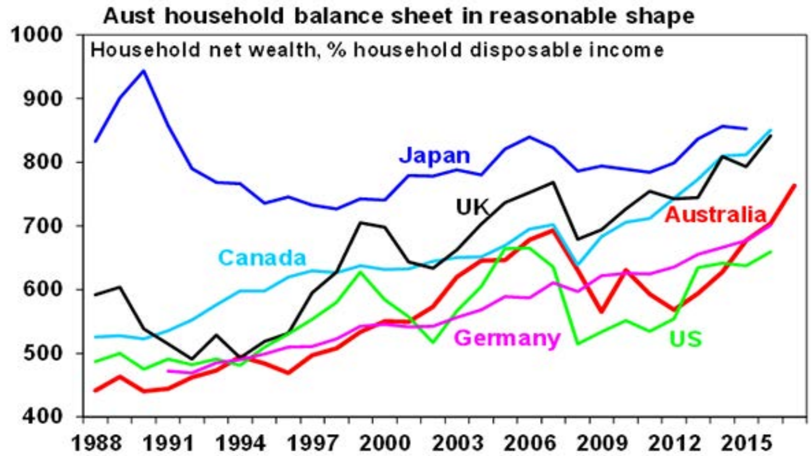
Over the last 50 years or so, Australians have borrowed more and more money to live.

There are several different ways to interpret the risks created by this.

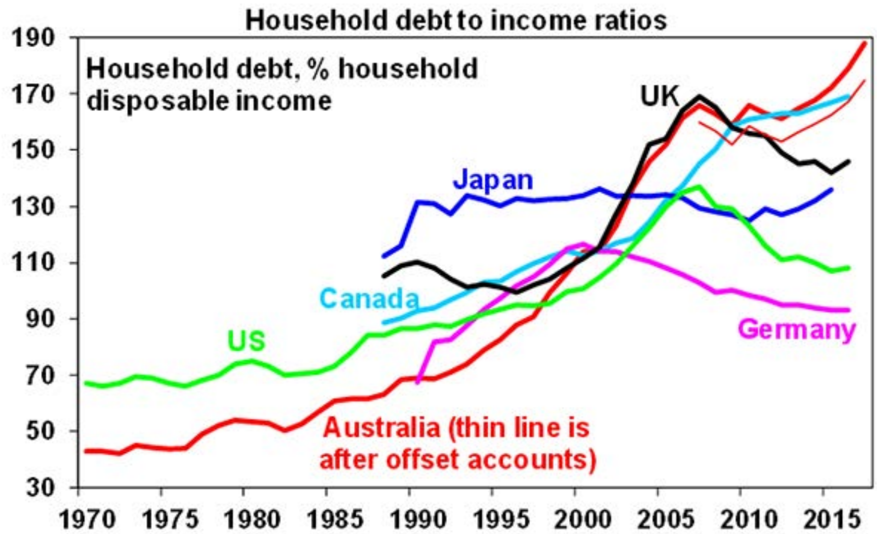
This chart (all charts courtesy of AMP) shows that Australians are actually spending less on interest repayments than they were around the time of the GFC. However we are very susceptible to higher rates. It won't take much in the way of higher borrowing rates to crimp our ability to spend and confidence to keep doing so.




The chart below shows that Australians are not so heavily geared if we take account of the balance sheet. While true, it is somewhat misleading. The reality is, if property prices and/or the stock market fall, this healthy balance sheet can deteriorate rather quickly but it looks OK at this time.




This is the big one, due to lower borrowing rates, higher asset prices and a complacency by households to live with a great deal of debt, our debt to income ratio is the highest in the world. This obviously suggests that the single biggest risk imposed by such high levels of debts is income. If unemployment rises or wages fall the impact of this high level of debt will be magnified. There is virtually no margin for error.




## Conclusion

We are not making predictions on all this, what we are trying to do is highlight structural issues that may have a significant impact on our downside assessment analysis when trying to buy stocks. There are many companies that will get hurt if this situation turns nasty. We are avoiding the high-risk areas despite some parts of the market appearing cheap.

Our largest single investment remains FSA group. It reported a solid but unexciting half year profit last month. The company is on track to deliver on its 5year program outlined over 2 years ago. We will bank another dividend this month. FSA (via its debt services division) has positive leverage to a pick up in financial stress in Australia. The services division (which helps people in financial stress) is not currently growing strongly but it is well positioned if the structural issues outlined above start to cause more stress on households.

FSA is trading at 12x FY18 forecast NPAT and providing us with a fully franked div yield of 4.5% while channelling the retained profits into its faster growing car and home lending business.

Management is progressing carefully on the lending side, fully aware of the levels of debt in the economy. Its services business puts it in a very strong position to lend responsibly and understand its customers and their capacity to service debt.

We remain happy holders.

**BIG VS SMALL**

Veteran small cap investor Peter Guy recently wrote an article for Allan Kohler's website and I have included a link below. It is a nice explanation describing the structural advantages of small caps and small fund managers vs. the larger members of the industry.

https://theconstantinvestor.com/big-versus-small/

**State of the Market**

I was asked what the state of market was recently and replied as follows: *It's half past midnight, everyone has been partying and enjoying themselves since 7pm. The police have come and turned the music off. Everyone is now looking at the stereo and wondering if they should switch it back on and party until the police return.*

For what it's worth, I think the amazing low volatility bull market we saw in 2017 is probably finished. The broader market is fully priced, interest rates are rising in most countries, and inflation is picking up too. We are likely to see more volatility and the broader market will struggle against climbing rates.

We have positioned the portfolio conservatively owning small companies that are generally on earnings multiples around 10x, paying us a dividend and with growth that should provide us satisfactory returns. **In the last few weeks we have seen a reduction in liquidity in small/micro caps.** We are seeing this impact our short-term performance results but the underlying fundamentals of our stocks have not changed. Interest in the space will return and as our companies perform, we expect to see share prices respond.

**Please don't hesitate to contact us to discuss any potential investment in the fund.**

**Performance of founder's units to 31 Jan 2018:**

| **Period** | ***Fund** | **ASX 300 Accumulation** | **Outperformance** |
|---|---|---|---|
| **1 Month %** | **-1.17%** | 0.34% | -1.50% |
| **3 Months %** | **0.05%** | 1.8% | -1.75% |
| **6 Months %** | **6.42%** | 7.72% | -1.30% |
| **1 Year %** | **3.78%** | 10.34% | -6.55% |
| **Since inception (Nov 2014) p/a *** | **6.93%** | 9.08% | -2.15% |

Fund Size $13m *Assumes reinvestment of distributions.

Good investing,
Nigel Littlewood
7th Mar 2018

Note: Harness Asset Management Small Companies Value Fund (the Fund) own shares in the stocks mentioned above as at 28 Feb 2017. The above is in no way intended as financial advice, nor any recommendation by the manager of the fund.