31 December 2014

FORAGER

# WHOLESALE VALUE FUND DECEMBER 2014 QUARTERLY REPORT

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# WRAPPING UP A ROUGH YEAR

Cheap money and ebullient investors are making life difficult for value investors. As 2014 comes to a close, we reflect on our performance and why patience is more necessary than ever.

Dear Investor,

The Forager Wholesale Value Fund produced mediocre return in 2014. The Fund returned 1.8%, roughly 3% less than its benchmark. We will have much worse years than this, of course. But the turning of a new year is always time for reflection, one where as investors we walk that fine line between learning our lessons and beating ourselves up too much about not predicting the unpredictable.

My reflections on 2014 fall into three main categories then. Things we got right. Things we got wrong. And things that are largely outside our control and will even themselves out in the goodness of time.

### FIRST THINGS FIRST, THE STUFF UPS.

Our mining services investments were far too early. The Fund hardly had any exposure at the start of the year, but managed to lose about 6% of its net asset value due to investments in the space during 2014.

As we argue on page 4, it is always easy in hindsight. Of course we could have waited, but there are plenty of examples of stocks where we 'could' have waited but didn't and made a lot of money.

### TOO EARLY TO THE MELT DOWN

Still, there is a lesson here. Those stocks that rose immediately were bought in what I would call a normally functioning market. Good businesses at reasonable prices from a seller who is not under duress.

The mining and mining services sectors are in melt down. A meltdown that we knew was coming (see for example "***China's unravelling starts to hit home***", "***The coming China crash: are we there yet***?" and "**China wobbles worth worrying about**") and spent the previous four years preparing for.

It is now a dislocated market where previously optimistic owners are selling shares without any consideration of price. They just want out.

Dislocated markets are where we make the bonanza returns, but doing so requires being selective and even more patient than usual. It is our view that we are going to make money on the initial purchase prices of these stocks and a lot of money from here. We could have made a lot more had we waited for the serious distress to set in.

This area is where the bulk of the underperformance arose in the past year. Offsetting that, we've got a few things right.

Forager's long-held view that Chinese economic growth would slow dramatically and a corresponding preference for businesses with foreign currency exposure has stood us in good stead. US industrial property group **Mirvac Industrial Trust** saw the last pages of its life written, the last few chapters of which have been very profitable for the Wholesale Fund. Other similar holdings have enabled us to sleep well at night while investors start to panic about the state of the Australian economy. For example, **Hansen Technologies** and **GBST** have performed well at both an operational and stock price level.

It's important not to confuse luck with skill in a bull market. And I would like to see us find more of them. But our process for identifying high quality opportunities is producing good results.

### PLEASE SEND ME SOME PESSIMISM

Finally, perhaps most importantly, despite a few blips during the course of the year, global equity investors remain ebullient. That makes it hard for us to find bargains. Cash balances have been a significant drag on performance. The reason equity markets keep rising is not difficult to discern. Interest rates around the world are at or near zero. Where else are you going to put your money?

That is an understandable reason for investing in equities. It is not an adequate one for us. Blindly chasing yield in riskier asset classes is a sure way to put a significant dent in your savings.

Thanks to turmoil in commodities markets, today's opportunity set is already better than it was 12 months ago. But we could do with more widespread pessimism in order to put our cash to work.

Whether in the next 12 months or the next 12 years, the tide will turn, equities will once again be viewed as unattractive and the prospective returns will more than compensate for the associated risk.

Until that point, we will strive to find what opportunities we can and eke out the best returns possible.

Kind regards,

**STEVEN JOHNSON**
**Chief Investment Officer**

# WHOLESALE VALUE FUND

## FACTS

| | |
|---|---|
| **Fund commenced** | 2 September 2004 |
| **Minimum investment** | $10,000 |
| **Income distribution** | Quarterly |
| **Applications/Redemption** | Weekly |

## UNIT PRICE SUMMARY

| | |
|---|---|
| **Date** | 31 December 2014 |
| **Buy Price** | $1.3819 |
| **Redemption Price** | $1.3751 |
| **Mid Price** | $1.3785 |
| **Portfolio value** | $24.42m |

# WHOLESALE FUND PERFORMANCE

After a couple of bountiful years the Forager Wholesale Value Fund ran out of puff in 2014. Investments in mining services companies hurt the performance this year but should prove rewarding in the long term. term either.

There are two reasons for the modest returns this year. Chart 2 provides the first answer, comparing the contribution of the best performing stocks to Fund's returns this year and last. You can see the contributions of the best performers last year tower over this year's best, last year RNY Property Trust (RNY) for example contributed more than 9% to the return of the *whole portfolio*. In a concentrated portfolio like the Wholesale Value Fund, big wins can really move the dial. And 2014 was essentially a year with no big wins.

**Table 1: Summary of returns as at 31 December 2014**

| | Forager Wholesale Fund | ASX All Ords Accum. Index |
|---|---|---|
| 1 month return | –1.02% | 1.93% |
| 3 month return | –2.73% | 2.58% |
| 6 month return | 5.38% | 2.28% |
| 1 year return | 1.89% | 5.02% |
| 2 year return (pa) | 19.89% | 12.10% |
| 3 year return (pa) | 19.67% | 14.30% |
| Since inception* (pa) | 7.28% | 8.51% |

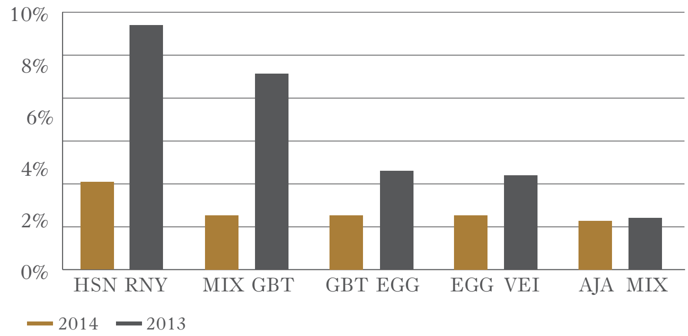
*Inception 2 Sep 2004

**Chart 1: Comparison of $10,000 invested in Forager Wholesale Fund vs ASX All Ordinaries Accum Index**


The big wins that drive returns are a function of good stock-picking, patience and luck. They don't, of course, arrive with any type of consistency, and that is why lumpy results are to be expected (and have been experienced) with this Fund. There's nothing that was done so differently in 2014 as to 2013 to explain the huge difference in results. The factor most controllable, the stock-picking effort, went well in 2014 with a number of promising ideas added to the portfolio that should help future returns.

The other factor curtailing returns was our collection of new investments in the mining services sector. Combined, these investments lost the Fund around 6% of net asset value. That's unfortunate, it always is to lose money, but it goes hand in glove with the investing strategy of the Fund – results vary and losses will be worn from time to time.

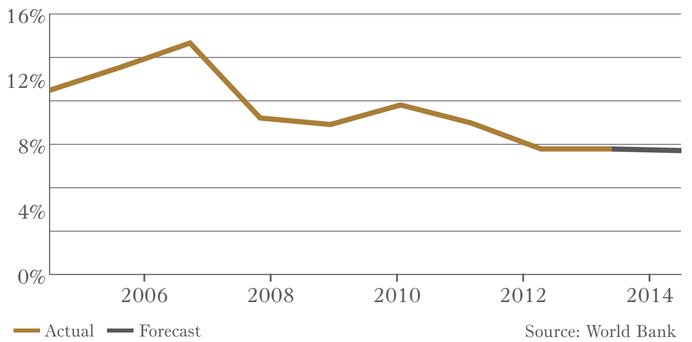
**Chart 2: Top 5 contributors to Wholesale Value Fund returns**




Despite the heavy falls before the Fund bought, clearly we moved too early into mining services. That's only obvious in hindsight though. Low prices at the time more than factored in the bleak outlook, and the danger with waiting too long is you risk missing the opportunity. This certainly could have happened with other Fund investments like **GBST Holdings** (GBT), **Hansen Technologies** (HSN) and **Brierty** (BYL) which delivered gains immediately after being purchased.

It's impossible to know in advance how low prices will go. Other sharemarket investors look to the future too, and prices rally in anticipation of better times well before conditions improve on the ground.

**Chart 3: China GDP growth**




Source: World Bank

Though it would be nice to enter at the bottom and though the Fund is wearing early losses, further capitulation in mining services *helps* the Fund. This is because it improves the opportunity set in which to invest. Businesses like **Macmahon Holdings** (MAH) that were cheap are now even cheaper and the Fund has been able to top up. Long term that's ideal and mining services remains a prospective area.

# "THOUGH IT WOULD BE NICE TO ENTER AT THE BOTTOM, FURTHER CAPITULATION IN MINING SERVICES *HELPS* THE FUND. IT IMPROVES THE OPPORTUNITY SET IN WHICH TO INVEST"

In the December report last year we cited the risk of a slowdown in China and the need for currency diversification to shield from knock on effects to the Australian economy. Both themes have played out this year. Chinese growth has moderated, making havoc for domestic iron ore producers who had bet China would grow 'stronger for longer', and the Australian dollar weakened 8.5% to US$0.82 in 2014.

The Fund did nicely with its US dollar exposure through contributions Hansen Technologes (HSN) and **Enero Group** (EGG), which derive significant portions of revenue outside Australia, and also from the now wound-up **Mirvac Industrial Trus**t. But despite owning nothing but United States office property, the unit price of the Fund's largest investment RNY drifted around seemingly uninfluenced by currency or a strong US economy, up only 1.8% in 2014. That shouldn't trouble us unduly, value has increased in Australian dollars and the Fund will benefit eventually either through distributions or asset sales.

## JUMBO EYES JACKPOT ABROAD

Another stock which hindered returns in 2014 was **Jumbo Interactive** (JIN), an online-seller of lottery tickets. We haven't said much about this business while we slowly increased the Fund's holding, but with the share price  down significantly and the Fund's  holding up, it's another holding primed to provide good returns over the coming year.

A large and well established online lottery ticket retailer should be a fantastic business, costs are relatively fixed and players are flocking online in big numbers. A brief look at the share price chart suggests Jumbo has its problems, though. They start at home.

With a database of 1.7 million customers, Jumbo's established (and profitable) Australian business is the largest independent seller of lottery tickets in the country. Unfortunately, Jumbo doesn't run its own lotteries. It is merely an authorised retailer for **Tatts Group** (TTS), which has managed to buy itself a monopoly on lotteries in Australia.

Under new management Tatts is focussing on its own website and gaining customers rapidly. Jumbo has still been growing, but Tatts has been growing faster. In addition to this unwelcome competition, Tatts has declined to renew Jumbo's long-term resale agreements. That means that at any time Tatts wishes, it can pull the rug out from Jumbo's feet and cripple its Australian operations.

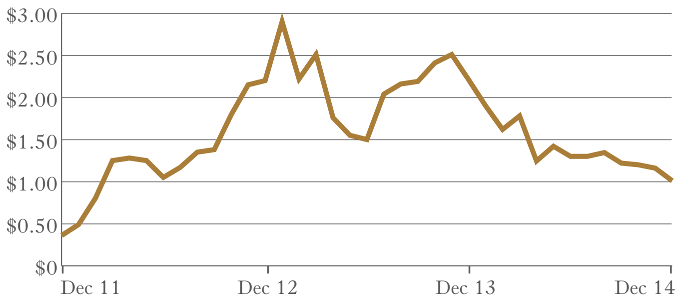
To reduce its dependence on Tatts, it has its eyes on riches in Germany, Mexico and the United States. Despite significant amounts of money spent, the only place where it is operational is Germany, and that isn't going well.

The battle to sign-up customers in Germany, where online lottery sales were recently legalised, is fierce between state lottery websites and private competitors. While its largest private competitor has been signing up 75,000 customers a quarter, Jumbo's sales have been so anaemic that Jumbo hasn't even been willing to disclose them. In a public relations era of carefully crafted market announcements, you can safely assume everything you aren't told is bad.

It's early days and management are looking to differentiate the offering to players, but despite a fair chunk of money having being spent setting up in Germany, Jumbo looks to be holding a weak hand.

The market is rightly nervous about all of these issues and the share price has been hammered. To the point where we think it has become absurd.

**Chart 4: Jumbo stock price**




The risk from Tatts is real, but the tiny market capitalisation of $45m now surely overstates it. Signing up new customers is painful due to anti-money laundering compliance. If Tatts were to terminate Jumbo's agreements, it will lose Jumbo's active lottery players for its trouble. Getting them back would be a headache and probably expensive. It is probably easier to simply buy Jumbo or retain the status quo.

Jumbo has $16m of free cash, so investors are only paying $29m for the Australian business. Excluding marketing, website development, and international expansion expenses (real outlays, but discretionary and mostly made to improve future profitability), operating earnings last year were $13.9m before tax. There's a good earnings stream if Tatts doesn't squash it, and on top there is a chance the German or other international jurisdictions take off in a big way. At worst management, with a big ownership interest in the company, should remember W.C. Fields' advice: "If at first you don't succeed, try, try again. Then quit. There's no point in being a damn fool about it".

That would leave a very valuable Australian business. Even If Tatts does move to shut down the Australian business, all is not lost. Jumbo retains ownership of the customer database, which has significant potential marketing value to other online gaming and betting websites (another reason Tatts should keep Jumbo within the fold), the free cash and international operations. With the downside less than catastrophic and some chance of hitting the proverbial jackpot offshore, it's a nice addition to the Fund portfolio.

"IN A CONCENTRATED PORTFOLIO LIKE THE WHOLESALE VALUE FUND, BIG WINS CAN REALLY MOVE THE DIAL. AND 2014 WAS ESSENTIALLY A YEAR WITH NO BIG WINS"

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