FORAGER

31 March 2016

A CROWDED WORLD OF DISTORTED ASSET PRICES
Zero interest rates are creating expensive asset prices and the lemmings are out in force.

WHITEHAVEN IN AND OUT OF WHOLESALE FUND
The latest addition to the Fund lasted just three weeks.

SERVICE STREAM BACK IN FAVOUR
After a few years in the dog house, Service Stream is once again in favour with fund managers.

WHOLESALE VALUE FUND MARCH 2016

QUARTERLY REPORT

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A CROWDED WORLD OF DISTORTED ASSET PRICES

It has been a volatile and busy quarter for the Forager investment team. Some old investments have made way for new and an old employee has done the same.

Dear Investor,

Value investing is supposed to be a staid business, identifying attractive investing opportunities and holding them for years. But when the share price of a company you are interested in halves and then doubles in the space of a few months, one must get busy.

And busy we have been. I don't have any figures to back this up, but I would guess the first three months of 2016 saw us do more trading than during any quarter of the past six years. The shares of **South32** (ASX:S32), a company with a rock solid balance sheet and some of the world's best mining assets, closed at $1.065 on 31 December 2015. They traded down to $0.89 on 21 January and then rallied 85% to $1.65 on 14 March. On 8 March, 121 million shares changed hands, more than 2% of the company's total shares on issue.

There wasn't much of note to report during the period. Most commodity markets remain oversupplied and there seems little prospect of a meaningful change in the short term. At a briefing breakfast after reporting its half year results, South32 CEO Graham Kerr said they will need at least 12–18 months of low prices to permanently remove excess supply from the market.

We're not complaining. Keeping busy has been very profitable (see **Whitehaven Coal** (ASX:WHC) on page 9). But what is driving such extreme share price volatility? And should we be concerned?

Without professing to understand the madness of crowds, there are a couple of clear themes influencing the current market environment.

First, there is a lot of money looking for a home that isn't a zero-interest bank account. Rare Ferraris are selling for €32m, Picassos are selling for US$179m and dingy one-bedroom apartments in Sydney go for more than a million bucks. These are not unrelated events. Cheap money is causing all sorts of distortions in global asset prices.

It is very clear that, after seven years of experimentation, ultra-low interest rates are not having the desired impact on global economic growth. Monetary policy is a very blunt and ineffective tool and, without help from sensible fiscal policy, it cannot single-handedly rescue the world. What it can quite clearly do is create asset price distortions and the sorts of wild market swings we have seen this past quarter. And yes, this aspect of financial market volatility is worth worrying about.

NOT SO MARKET NEUTRAL

The second factor is as old as financial markets themselves — the propensity for investors to crowd into small pockets of the market where they feel they are safe (usually those pockets that have performed well in the recent past).

One of our investors asked me a few questions about an unrelated hedge fund earlier this year. My brief observation was that the performance was excellent but that there was nothing hedged about it. The fund in question falls into the "market neutral" category, where the manager tries to offset their long positions with an equivalent amount of shorts (bets that share prices will decline). The idea is to make money irrespective of the overall market's movements. For example, you might go long a selection of stocks and short the whole market, or long **Commonwealth Bank** (ASX:CBA) and short **ANZ** (ASX:ANZ) because you think the former is more attractive.

The asset allocation diagram for this fund showed that it was short mining companies and long every other sector. There is nothing wrong with that, it was the right call in 2015 and explains the excellent performance. But it is a leveraged bet on the theme, not something that should be marketed as "neutral".

As a final check I went and took a look at a few of the hedge fund's direct competitors in the market neutral space. They have all been having a merry time of it (hence the proliferation of market neutral LICs of late). And, surprisingly to me, they all had exactly the same market positioning. Short mining, long everything else.

The homogeneity of the strategy explains a lot. When everyone is crowding into the same small parts of the market, you can see wild swings in the prices of reasonably large stocks like South32. The volumes and magnitude of the rallies in South32 and Whitehaven looked to me like hedge funds desperately needing to unwind their bets, all of them at the same time.

Lemming-like behaviour is nothing new in financial markets, but it does seem more pervasive than ever before. Those companies in favour — particularly good businesses with growth prospects — are extremely expensive. Those out of favour can get absurdly cheap.

Finally, I was fascinated by the fact that, from what I could tell, not one of the funds I looked at had taken their profits on their mining shorts. I am as bearish on China as anyone, but the share prices of companies like **BHP Blliton** (ASX:BHP) and **Rio Tinto** (ASX:RIO) were starting to factor in a particularly bleak future.

It's very easy to fall in love with a winning strategy.

At the depths of the financial crisis in 2009, GMO's Jeremy Grantham wrote that the few brilliant souls who went into the financial crisis with large cash weightings would "not want to easily give up their brilliance". It is not that different when you have been short mining and short China and seen that strategy

“OVER THE LONG TERM, GETTING THE VALUATIONS RIGHT IS WHAT COUNTS. THE SOONER THE BETTER, OF COURSE, BUT IF WE ARE RIGHT ON VALUATION THE GAP WILL EVENTUALLY CLOSE.”

pay huge dividends. To turn around and buy the same stocks you have been publicly avoiding requires overcoming some very strong emotional biases.

Perhaps putting **RNY Property Trust** (ASX:RNY) to one side (see page 7), our efforts at overcoming this inertia bias are something I am extremely proud of over the past year or so. We have forced ourselves to look in maligned parts of the market and materially improved our portfolios as a result.

Kind regards,

STEVEN JOHNSON
Chief Investment Officer

“IT IS VERY CLEAR THAT, AFTER SEVEN YEARS OF EXPERIMENTATION, ULTRA-LOW INTEREST RATES ARE NOT HAVING THE DESIRED IMPACT ON GLOBAL ECONOMIC GROWTH. MONETARY POLICY IS A VERY BLUNT AND INEFFECTIVE TOOL AND, WITHOUT HELP FROM SENSIBLE FISCAL POLICY, IT CANNOT SINGLE-HANDEDLY RESCUE THE WORLD. WHAT IT CAN QUITE CLEARLY DO IS CREATE ASSET PRICE DISTORTIONS AND THE SORTS OF WILD MARKET SWINGS WE HAVE SEEN THIS PAST QUARTER.”

WHOLESALE VALUE FUND

FACTS

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

UNIT PRICE SUMMARY

Date	31 March 2016
Buy Price	$1.5258
Redemption Price	$1.5182
Mid Price	$1.5220
Portfolio Value	$23.9m

GOOD, BAD AND LUCKY IN THE WHOLESALE VALUE FUND

There have been some big changes to the Forager Wholesale Value Fund during the March quarter. Some long held companies have excelled, some have disappointed and a new stock has enjoyed a very short stay.

Table 1: Summary of returns as at 31 March 2016

	Wholesale Fund	S&P All Ords. Accum. Index
1 month return	5.47%	4.74%
3 month return	7.78%	–2.35%
6 month return	18.13%	4.11%
1 year return	19.52%	–8.05%
3 year return (p.a.)	16.02%	5.63%
5 year return (p.a.)	17.49%	5.43%
Since inception* (p.a.)	8.61%	7.68%

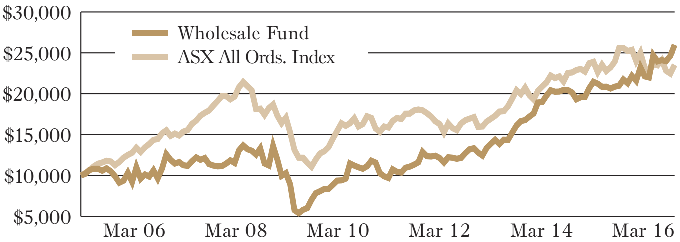
*Inception 2 September 2004

A potential investor walks in to the Forager offices. "Mr Johnson", he says, "the right hand side of this February report I have in my hand says your fund is performing exceptionally well. The left hand side, where you explain what is happening, contains nothing but bad news."

That's a made up version of a real conversation. Our February report contained some bad news about some of our core holdings (most importantly, see RNY on the right).

This is not an unprecedented event. Successful investing has two components. Part one, accurately identify the value of a company and buying it for significantly less than that valuation. Part two, holding on to it until the gap between the two closes.

Chart 1: Comparison of $10,000 invested in the Wholesale Fund and ASX All Ords. Index



We are constantly receiving information, like half yearly results, that helps determine whether our valuation is correct, too high or too low. Results received in February suggests some of our valuations are too high. But we also saw the values of other core holdings affirmed and, importantly, increasingly reflected in the share price (see **Service Stream** (ASX:SSM) on page 9).

Over the long term, getting the valuations right is what counts. The sooner the better, of course, but if we are right on valuation the gap will eventually close. Which is why, despite share prices going up, it was a mildly disappointing reporting season.

There will be periods where exactly the opposite happens. Results can be good, our valuations correct, and share prices fall even further. When that happens, we'll tell you we are doing well even when you can't see it in the unit price.

Table 2: Top 5 Investments

Service Stream	11.8%
Macmahon Holdings	8.4%
Reckon	6.0%
Enero	5.9%
GBST Holdings	5.1%

RNY STUCK WITH NO HIPSTERS IN SIGHT

First purchased in 2010, RNY Property Trust has been one of the largest holdings in the Forager Wholesale Value Fund for more than five years. Until recently, it was also one of the most significant contributors to the Fund's excellent performance over that period.

The trust owns a collection of US office properties in New Jersey, Westchester and Long Island, areas within commuting distance of Manhattan. Buying in the aftermath of the financial crisis, our thesis was threefold: that the huge gap between RNY's unit price and its net tangible assets (NTA) would narrow; that the NTA itself would increase as the US economy recovered; and that buying assets in the US was a good idea with the Australian dollar at better than parity with its US counterpart.

The Aussie dollar has fallen and, in 2012, management were able to arrange some advantageous debt relief, increasing the NTA to unitholders. But, despite robust employment markets, the underlying asset values had failed to budge. In fact, according to the last results release, they have fallen.

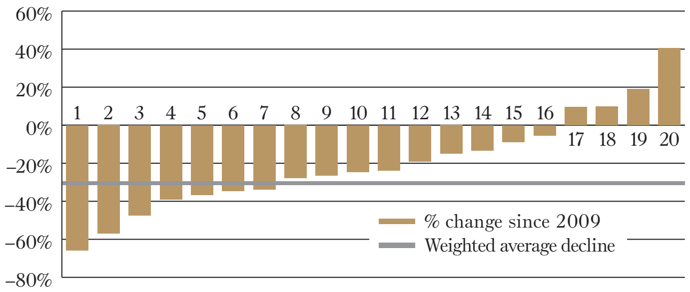
In some cases that fall has been precipitous. The Trust's office property at 100 Executive Drive in New Jersey was on the books at almost US$12m six years ago. Today it is apparently worth $4.1m, a 66% decline. Two nearby properties have seen their values fall by almost as much.

In total, the remaining properties are worth 30% less today than their December 2009 valuations, and it remains to be seen whether the updated values can be realised.

In a world of zero interest rates and skyrocketing prices for every asset imaginable, this is disappointing to say the least. After waiting years for Manhattan's optimism to spread to the suburbs, it's time to recognise that there is a problem.

> "YOU WOULD THINK THAT ONE OF THE ADVANTAGES OF SELECTING A FUND MANAGER WHO ENJOYS THE INNER CITY LIFESTYLE HIMSELF IS THAT HE COULD AT LEAST WORK OUT WHAT HIS COMRADES ARE UP TO."

Chart 2: RNY's Declining Property Values



1	100 Executive Dr, Northern New Jersey	11	6900 Jericho Turnpike, Long Island
2	10 Rooney Circle, Northern New Jersey	12	35 Pinelawn Rd, Long Island
3	200 Executive Dr, Northern New Jersey	13	80 Grasslands Rd, Westchester County
4	555 White Plains Rd, Westchester County	14	710 Bridgeport Ave, Fairfield County
5	300 Motor Parkway, Long Island	15	300 Executive Dr, Northern New Jersey
6	560 White Plains Rd, Westchester County	16	200 Broadhollow Rd, Long Island
7	150 Motor Parkway, Long Island	17	660 White Plains Rd, Westchester County
8	6800 Jericho Turnpike, Long Island	18	492 River Rd, Northern New Jersey
9	55 Charles Lindbergh Blvd, Long Island	19	580 White Plains Rd, Westchester County
10	225 High Ridge Rd, Fairfield County	20	100 Grasslands Rd, Westchester County

That problem is that companies increasingly don't want to rent space in RNY's suburban office properties. New generations of workers want to work in a highly urban environment. Whereas 20 years ago, living in the suburbs and being able to drive to work was seen as an advantage, today's workers want to live in the city. Even those whose employers can't afford an office in Manhattan want to live in neighbouring borough Brooklyn and commute back out to the suburbs.

So the gap between CBD office rentals and suburban office space has widened into a gulf and, even within the suburbs, offices easily accessible by public transport are commanding massive premiums compared with those, like most of RNY's, that aren't.

The net result is that occupancy levels at RNY's office buildings have slipped to a weighted average of 75%, well below the historical average of 90% used in RNY's valuation models. With the trend looking more secular than cyclical, the values quite clearly needed to come down.

If you are looking for someone to blame, look no further than us. It is our job to identify and weight secular issues like this. And you would think that one of the advantages of selecting a fund manager who enjoys the inner city lifestyle himself is that he could at least work out what his comrades are up to.

We're still hoping for a decent outcome. Management claim the revalued asset backing of US$0.26, well north of the current unit price of $0.13 per unit, represents a realistic estimate of the liquidation value of the assets. And they have indicated that the properties could be sold and the trust wound up within 12–18 months.

With lots of leverage and no real evidence of a liquid market for the assets, though, it is hard to have any conviction.

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MARKET COMES FULL CIRCLE ON SERVICE STREAM

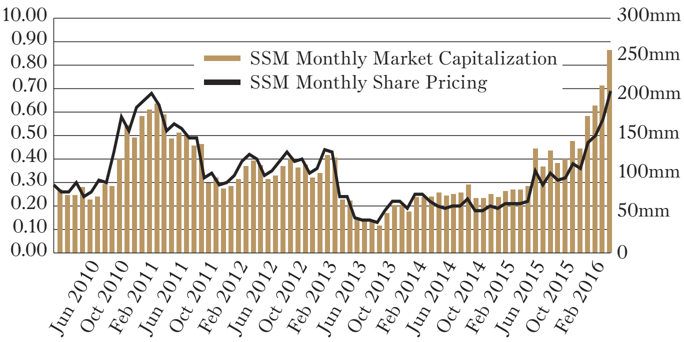
Through 2010 and into early 2011, utilities contractor Service Stream was one of the ASX’s darling stocks. Although Kevin Rudd no longer had his job as Prime Minister, the Rudd government’s 2007 election promise of a National Broadband Network was finally becoming a reality and Service Stream was to play a key role in its delivery.

A \$107m loss in 2013 put paid to the optimism. Far from being a source of growth, round 1 of the NBN turned out to be a life threatening calamity for the company, as fixed price contracts were unable to be profitably delivered.

Service Stream’s market capitalisation fell from more than \$200m to less than \$40m and an emergency capital contribution was required to ensure the business’s survival. The Fund acquired most of its position in that capital raising.

It spent the next couple of years in the institutional investor dog box. “Ye shall not be spoken to”, say the institutional investors, “until you serve your time for the sins of the past”.

Chart 3: Service Stream Share Price and Market Capitalisation



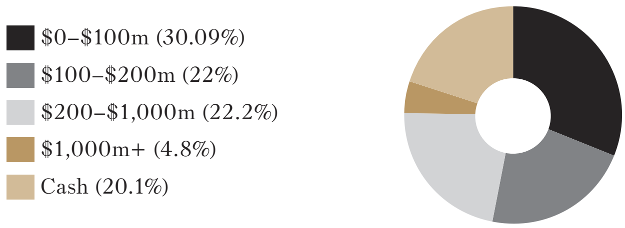
You may think it no bad thing being left alone to run your business and we tend to agree. We encouraged the new management team to forget about the market and use the peace and quiet to get on with returning the business to sustainable profitability.

That they have done an excellent job of. And, while we would be perfectly happy for the company to remain in the nirvana state of increasing profits and low expectations, fellow fund managers are finally starting to take notice. Wilson HTM became the first broker to recommence coverage on the stock earlier this year, the volume of shares traded has increased dramatically and the share price has almost tripled in the past 12 month.

We are now left with some difficult decisions to make. The expectations on the company are still undemanding. It is due to return \$0.05 per share in capital in May and it could be worth more than \$1 a share if the next 24 months go to plan. In fact, it is the stock in the portfolio we are most confident can grow revenue and profit over the next few years.

The portfolio weighting has increased with the share price, though, and at one point was approaching 15%. That’s too much for a stock with a decreasing margin of safety. Roughly a third of the fund’s holding was sold in March and you should expect more to be sold if the price continues to rise.

Chart 4: Portfolio Distribution According to Market Cap



WHITEHAVEN DELIVERS A WINDFALL GAIN

The typical holding period for the Wholesale Fund is roughly three years. Sometimes we will hold a stock for a lot longer than that (several of the Fund’s current holdings have been part of the portfolio since our first year of operations).

The philosophy is simple. We buy a stock when we think it is trading at a meaningful discount to our valuation of its future cash flows. We sell it as the market starts to recognise that value and the security’s price approaches fair value. That can take a long time. Or it can take three weeks, as in the case of the recently bought (and sold) **Whitehaven Coal** (ASX:WHC).

Whitehaven’s two main assets are long-life and low-cost coal mines in Narrabri and Maules Creek. The former has a remaining life of at least 20 years and the latter has only just begun operations and has at least 30 years to run.

Whether the world is going to need its production in 30 years’ time is questionable. What’s clear is that there is too much coal being produced in the here and now. Consultancy Wood Mackenzie reckons an extraordinary two-thirds of the world’s coal is currently being mined at a loss.

The solution to the industry’s woes is to shut those mines that are losing money but, thanks to state-owned mines running at a loss to save jobs and high sunk costs relative to ongoing operational expenses, that hasn’t yet happened.

Whether it takes one, five or ten years for the adjustment to take place is not something we have a strong view on. What we are interested in is the optionality Whitehaven provides on it being soon enough for the company to survive.

The company’s survival is not imperilled by the quality of its assets. Whitehaven is in the one third of the industry that is profitable even at today’s low prices. Rather it is the debt that was used to develop Maules Creek that is the problem.

The company owes \$925 million in net debt. That doesn’t look much next to \$4.2bn of assets but, relative to the \$60m of

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earnings before interest and tax it earned in the six months to 31 December, it is looking stretched. The first big test comes when it must meet covenants for the first time in December this year. If the coal market has deteriorated further, the company will likely be in breach and its future in the hands of its bankers.

All of that explains why the share price had fallen from north of $7 in 2011 to less than $1 prior to Christmas.

We first took a look at around the $1 per share level and fairly quickly dismissed it thanks to too much debt and not enough potential upside. We took a more detailed look at $0.60 and still decided not to pull the trigger.

In the market panic of January and early February, however, we decided that the price of less than $0.40 was too good to refuse. To understand why we would buy a company that might go bust, you need simply to understand the upside.

At a price for thermal coal of US$50 a tonne, the company is barely profitable. At $70 a tonne, a level at which much of the rest of the industry is still unprofitable, our estimate of value is a little over $1 a share. At a more optimistic $100 price level, Whitehaven could be worth $5. That scenario is unlikely in the foreseeable future, but you can see how sensitive the valuation is to relatively small movements in the coal price.

So we bit the bullet and took a small position in a stock where a possible 100% loss is more than offset by the potential to make four or five times our investment.

The stock doubled within three weeks of purchase.

It is important in these high-risk situations to make sure you profit sufficiently from the winners. We will lose money from time to time and, if we cash our chips in early on every winner, it is going to crimp our average returns. But this scenario is unique in that absolutely nothing has changed.

Usually the price has moved because a company is more or less likely to survive. If the odds have improved, it might pay to hang on to your lottery ticket. In this situation, the odds didn't change in the three weeks we owned it. In our opinion, it is just as likely to go bust as it was a couple of months ago. So a doubling of a share price simply put us back where we were late last year — too much downside and not enough upside from the $0.77 share price at which we sold.

Only time will tell how the Whitehaven option plays out and we might get a chance to own it again. For now, we've banked a lucky profit.

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