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December Quarterly Report

MACRO CAPITAL LIMITED
ABN 14 145 321 928 | AFSL: 392401

GANES INVESTMENT MANAGEMENT PTY LTD
ABN 86 113 032 741 | AFSL 287598

After recording approximately 17% return in calendar year 2013, a return that far exceeded the underlying performance of the economy, the local market has finished 2014 with a small positive return of 5.0% for the year, while we have recorded a 2.8% return.

Performance 31-Dec-14	Ganes	All Ord Index
1 Month	0.78%	1.93%
3 Month	1.65%	2.58%
6 Month	2.45%	2.28%
1 Year	2.83%	5.02%
2 Year (p.a.)	9.82%	12.10%
3 Year (p.a.)	13.09%	14.30%
5 Year (p.a.)	9.88%	6.44%
Since Inception (p.a.)*	7.37%	6.19%
NAV Unit Price ($)	1.4522	
Fund Assets ($ million)	36.50	

* Inception date of Fund 18/11/2005

The Fund produced a 17% return in calendar year 2013 despite holding the largest cash weighting in the history of the Fund. Therefore, if we were to outperform the market in 2014 we needed the existing portfolio to seriously outperform the market, find some attractive new investments to put our cash to use, or the market needed to fall and our cash provide a buffer to unit holders against this outcome.

As is the nature of things, some of these things occurred but some didn't. Our existing portfolio performed reasonably well, the market was flat rather than fell and we did managed to find some small opportunities to invest our cash. But these gains were not enough to offset the large fall in the price of Flight Centre, our largest holding. Flight Centre started 2014 as a market darling after a stellar year of profit upgrades in 2013 along with a strong share price gain. Fast forward 12 months and Flight Centre has finished the year as the most shorted company in the market and the share price has fallen 32% for the year. Unfortunately this has had the effect of taking about 4% off our annual return this year, but we are now more comfortable that the shares represent better value today than they did this time last year.

Stock Market Predictions

At this time of year, newspapers and media outlets are full of sharemarket predictions and what always surprises us is the confidence of these forecasts regarding such an unpredictable event. At the start of 2014 would anyone have anticipated that Qantas would rise more than 100% while Flight Centre would fall 30%? We doubt it. The headline in the Sydney Morning Herald of February 28 last year was 'Analysts predict more cuts for struggling Qantas' at the same time that Flight Centre had already risen 20% in just two months. In the article, a number of analysts were quoted, all expressing doubts and concerns about the business. Another headline only a month later was 'How Qantas went from national icon to corporate tragedy'. This is not a reflection on the journalists involved, simply to reflect the inherently difficult nature of making short term forecasts in complex systems and how quickly those predictions can look quite silly.

Top 10 Portfolio Holdings	%
Cash	22.01%
Flight Centre	7.90%
Woolworths	6.85%
Treasury Group Limited	6.61%
Austbrokers Holdings Limited	6.03%
Spark Infrastructure Group	5.58%
Magellan Flagship Fund	4.02%
ARP Corporation Limited	3.75%
Computershare Limited	3.66%
Sonic Healthcare Limited	3.55%
Other Holdings	30.04%
Total	100.00%

You can see then why we don't make predictions, we don't participate in the game of predictions and why we will never make promises explicitly or implicitly to you regarding fund returns. News headlines and market commentators are there to sell advertising space and one should always regard them in this light, not as information to be acted

MACRO CAPITAL LIMITED ABN: 14 145 321 928 AFSL: 392401
Postal: PO Box 558, Wembley WA 6913 Street:Unit 2, 55 Salvado Rd Subiaco WA 6008 Telephone: 08 9217 3100 Facsimile: 08 9217 3111
Website: www.macrofunds.com.au Email: madmin@macrofunds.com.au

upon.

In any endeavour where an outcome is not repeatable on a consistent basis by pure skill (such as gambling, most sports, and the sharemarket) then luck plays a large result in the short-term results. Over the long term the participants with superior skills should outperform, but in the short-term one should have the humility and good sense to accept the nature of luck in any outcome.

What we do try to do is estimate the future performance of the business, and this is very very different to predicting sharemarket price movements. We prefer to look at the underlying economics of the business and assess its merits for providing a good long term outcome for investors. The nature of our investment approach is to hold our investments for the long term, because eventually the share market performance should reflect the underlying performance of the business. We call these businesses compounding machines. And what we are ideally trying to find are businesses that can produce high incremental returns by being able to employ additional capital at attractive rates of return. If we return to Flight Centre, the share price has returned 10% per annum over the past decade (despite the fall of the last year), which is roughly analogous to the financial performance of the underlying business.

Other examples of businesses we like in this category are 4WD parts supplier ARB Corporation which has produced a 10 year return of 17% per annum and funeral home operator Invocare, which has provided a 10 year return of 18% per annum. We think spending time finding these types of companies and attempting to calculate whether the company can produce attractive incremental returns on capital over the long term are the best uses of our time rather than predicting an arbitrary number on an index, or worrying excessively about whether the price may rise or fall in the short term.

We would suggest that is how a wealthy investor would go about looking at buying the local newsagent or a McDonalds store rather than trying to predict the "newsagency or McDonalds index" and we try to invest in a similar fashion.

Tom Gaynor, Chief Investment Officer for Markel, someone that we greatly admire put it much better earlier this year, when he said;

"Most of the time and effort in the investment business is spent trying to figure out what something is worth in a very short time period. Professionals are consumed by questions such as, "Can a security be traded for more or less in a few nano-seconds through high frequency trading mechanisms?", "Are interest rates going to move up or down and what will that mean to this security trading price?", "Is Putin going to invade Ukraine, or Poland or .... and what will that do to stock prices?", "Will we reduce the federal budget deficit?" and so on and so on and so on. While those are all important questions, they pale in comparison to the task of finding a manager who can successfully produce earnings from a business, and reinvest those earnings profitably over long periods of time".

As we have said over the last dozen years, some years we will outperform the market and some years we will underperform but over the long term we believe our approach should see us deliver outperformance that is attributable to our skills rather than luck, and to that end our long-term track record is still superior to that of the market.

Interestingly, we recently read a study of US managed funds that identified that approximately 67% of funds underperform the market over the longer term. And this is despite the efforts some of the brightest knowledge workers and university graduates in the country.

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At this time of the year it is opportune to reflect on what worked in the portfolio (and our investment process), what didn't work, and more importantly what lessons we learnt from this. This is a business where continual learning and improvement is vital.

What worked:

1. We continued to improve our investment process and now have a comprehensive database that allows us to scour results for companies in the portfolio and pull apart results on a longitudinal basis. We think this will add value by both identifying when businesses are improving but also highlight when business performance is deteriorating - with a particular focus on returns on capital. This database is proprietary to Ganes and has involved many, many hours of work that may only be reflected in our returns over the long term. Nevertheless, the work has been done and only involves incremental hours to maintain now and should hopefully provide benefits to unit holders.

2. Our commitment to stick within our circle of competence saw us avoid many of the disasters within the resources and associated mining services industries. These sectors are now well and truly beat up with some share prices down 90% in just a year. There are probably some bargains in amongst them but we don't have the requisite skills to identify who will be the winners from the wreckage. No doubt some astute investors, and perhaps some lucky ones too, will make a fortune in this sector but it won't include us. We have a 'too hard' bin and mining services have been filed in there for now at least.

3. Our belief that the Australian dollar is overvalued and that exposure to international markets would benefit investors continued to play out again this year. Our most direct example of this is via Magellan Flagship Fund, a Listed Investment Company (LIC) that invests internationally without hedging its currency exposure. The share price was up a further 19% this year, but more importantly, has now returned 40% per annum for the past three (3) years. This is an outsize return that we could not have predicted when we started buying the shares in late 2010. We have made our returns from three components to the investment. First, when we started buying the shares they were selling at a discount to their net asset backing, meaning we were able to buy shares in companies such as American Express, Wells Fargo and Visa cheaper indirectly than we could directly. That discount has now disappeared and in fact the shares usually sell at a premium to NTA most days so the narrowing of the discount provided some return. Second, the underlying performance of the portfolio of international companies has performed well and the NTA has risen, and lastly the Australian dollar has fallen against the US dollar providing further returns to the portfolio.

Any of these factors may not have occurred but the nature of value investing is to buy at discount to our perceived intrinsic value so that not everything has to go according to plan in order to earn an attractive return. Ben Graham put this best when he said, "…the function of a margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future".

By contrast, investors that pay more for an investment than its intrinsic value require everything to go exactly to plan or even better - there is no scope for error - and hence the term 'priced for perfection'. We avoid companies that are priced for perfection, even though market performance is definitely on their side over the short term, to provide us with a buffer should something go wrong or not according to plan.

That is not to say we will never lose money on an investment, but it does provide us with some margin for error. And on that note, we should move on to what didn't work during the year.

What didn't work:

1. Being too conservative on valuations. We looked at many, many investments that we thought met our investment criteria, but they usually failed our valuation metric. Some of those companies went on to double in price in the past year or two. In hindsight, we should have lowered our valuation metric as interest rates declined and the value of franked dividends made equities more valuable as an asset class. We won't chase prices or tweak our valuation models just to make them line up with current prices but in hindsight, we could have relaxed our hurdle rates somewhat, and have done so in recent months. On balance, we would have performed much better in the past year or two if we had acted earlier on this.

2. Failing to predict the decline in the Coca-Cola Amatil business. This once great business is showing signs of stress as competitors aggressively attack them on prices, and the major supermarkets show no sign of abating their desire to extract value from their suppliers. We had exited all our investments in suppliers to the supermarket channel but thought Coca-Cola would be better placed to withstand this pressure, however, that has not proven to be the case. In addition, sustained competition on pricing is something new in this industry that we also failed to allow for. We believe the new CEO might provide better decision-making on strategy as she is not beholden to any sacred cows within the business, and has already started to drive product innovation (something else that has sadly fallen behind at the company). The share price was down 19% for the year, but more tellingly has provided a 10 year return of just 5.7%. We reduced our exposure but we should have been more decisive in our response.

3. Failing to grasp the poor execution of the Masters rollout at Woolworths. Given that Coca Cola has suffered at the hands of the supermarkets, it is somewhat ironical that we would include Woolworths in this list as well. The rollout of the Masters hardware division has been a failure at this stage by any account - over budget, delayed and moving targets on profitability. We believe Australia can support another big box hardware supplier and there is room for Masters, however, gaining access to sites and store formats have been far more difficult than the company had previously disclosed. Woolworths is an inherently attractive business with wonderful returns on capital but Masters is not going well and this has been reflected recently in the share price. With the recent decline in the price because of the uncertainty around the company we think the company may reflect better value than previously despite these concerns.

Plans for next year:

We have finished the year with our cash weighting reduced to 22.01% and we believe the portfolio offers much better value now than it has for some time. We also continue to find some companies that meet our criteria for quality with attractive business fundamentals and hopefully, given the nature of volatile share prices, we will get the opportunity to add these to the portfolio at some point during the year.

Our years of experience are both a benefit and handicap in life, but on balance we believe they provide us with the wisdom to add value in managing assets. We are always hopeful that we will continue to find some exciting new investment that ticks all our boxes, we found one in 2014, but we hope to find more in 2015. Finding someone that will manage your money as carefully as you would manage it yourself is not easy and we take our responsibility seriously to protect your investment as much as to grow it. For the trust you have placed in us we thank you and we never lose sight of our responsibility to you.

We look forward to your continued support in 2015.