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

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

March Quarterly Report

Market Returns and Portfolio Performance

Despite a strong 4.7% return in March the local market is still down 2.3% for this calendar year and down 8% for the past 12 months. By comparison, the Fund recorded a positive result of 2.5% for March, is down 7% last quarter and down 2% for the past year respectively.

We do not consider short-term results are an indicator of investment management skill, given the vagaries of the market and the particular skew in Australia to the banks and major miners, which play a big role in determining market returns. In fact, constant reference to short term results can lead to decisions that can seriously affect long-term results. Hence we try to focus on the business and not the share price, although that's much easier said than done at times.

Performance 31-March-16	Ganes	All Ord Index
1 Month	2.51%	4.74%
3 Month	-7.17%	-2.35%
6 Month	3.39%	4.11%
1 Year	-2.34%	-8.05%
2 Year (p.a.)	2.24%	2.05%
3 Year (p.a.)	4.96%	5.63%
5 Year (p.a.)	7.50%	5.43%
10 Year (p.a.)	6.44%	4.50%
Since Inception (p.a.)*	6.86%	5.56%
NAV Unit Price ($)	1.4097	
Fund Assets ($ million)	27.09	

* Inception date of Fund 18/11/2005

Under our preferred 5 year time frame, the Fund has produced a 7.5% pa return (net of all fees and transaction costs) against the market of 5.4% (where there are no fees or transaction costs), an outperformance of 2.1% pa. Over other longer time frames, the Fund has similarly outperformed the market.

To Index or Not

Fund managers can generally only add value in two ways; by stock selection or by weighting within the portfolio. As an active manager, we believe we add value by stock selection. That is, the Fund portfolio is constructed very differently to that of the index. In fact, we disregard the index weightings all together, hence our results will tend to fluctuate quite markedly against the index over the short term. Any correlation is more accidental than intentional but over the long term, our results will reveal if our investment approach has added value. For the past decade we can claim that it has.

Top 10 Portfolio Holdings	
ARB Corporation Limited	7.29%
Magellan Flagship Fund Ltd	6.81%
Flight Centre Travel Group	6.59%
Smart Group Corporation	6.55%
AUB Group Limited	5.15%
Adelaide Brighton Limited	4.72%
Beacon Lighting Group	4.38%
Cochlear Limited	4.32%
Templeton Global Growth Fund	4.13%
PM Capital Global Opportunities	4.10%
Other holdings	45.96%
Total	100.00%

Constructing a portfolio that is inherently different to the index does not guarantee above market returns, but it does at least provide the opportunity to do so. By its very definition, if fund managers construct a portfolio that closely resembles the index they can only expect market returns and hence can expect to struggle to outperform the market once all fees are taken into account.

With the advent of low cost index investing, an argument has been raised whether investors should pay for active management. We believe there remains a case for active investors for two reasons. Firstly, there is evidence that over the long term, concentrated portfolios can deliver outperformance and secondly with the flow of funds into index investing at some point when the funds flow out (as they invariably do in market downturns), the self fulfilling nature of index Funds selling should see index unaware Funds outperform. Of course, if a portfolio is poorly constructed using a flawed investment philosophy, then being index unaware is no safety net at all for investors.

To highlight how the Fund performance will differ to the market over short time frames, consider the recent mini commodity price boom. Despite concerns regarding China that were headline news at the start of the year, prices for many commodities such as iron ore and coal have experienced sharp price increases in recent months and as a result the share prices of many smaller resource companies have rebounded strongly.

We are not confident of the long term nature of these price rises given that the fundamental structure of the supply and demand equation has not changed but it was enough for the energy sector to enjoy a 6% return for the month. But investing is also about avoiding making errors as it is picking winners and the Fund isn't invested in the resources sector and hence has also avoided the 25% decline in the sector over the past year.

We have reviewed a number of mining service companies that appear good value at face value but we haven't ventured further. Usually a combination of a concentrated customer base, and customers that are struggling financially and who are determined to reduce their costs, especially their capital expenditure costs, leaves us cold regardless of the low price.

Quality is still our Mantra

We continue to look for what we perceive as quality businesses selling at reasonable prices, or preferably attractive prices, that we can hold for the long term and enjoy the results as shareholders of a successful and growing business.

We have recently read two excellent books that cover this topic very well. The first, Quality Investing: Owning the best companies for the long term by Laurence Cunningham does a great job in illustrating the points that investors should be looking for when seeking good quality companies. The author continually comes back to the point that the best companies earn high rates of return on their capital, but more importantly can incrementally grow that capital at attractive rates for extended periods of time. When this occurs, investors will prosper. We highly recommend the book.

This led to a second book written by Christopher Mayer, which covered 100 baggers: (shares that have increased 100-fold) and is aptly titled 100 Baggers. Again, the thesis of the book is to find companies that can grow and then hold onto them for the long term. In the case of 100 Baggers, the author generally found that 25 years is usual to achieve the result of turning $10,000 into $1,000,000, which represents a return of 20% per annum. And there are a surprisingly large number of them as outlined in the book. Even on a quick search, we found quite a number in Australia as well such as our largest holding **ARB Corporation**, which we have owned for over a decade and has gone from an adjusted 10c per share on listing to its current price of $15. The ability to compound capital at incrementally attractive rates begets growth and this is the single most important factor, growth in sales, growth in profits and ultimately growth in market valuation.

Patience

Patience becomes, and is, a critical element in the investment process. While being intelligent is obviously required, additional points of IQ don't usually help. Buffett has said "Investing is not a game where the guy with the 160 IQ beats the guy with a 130 IQ," hence why we see that despite some of the brightest financial graduates and brainpower employed in the finance industry we still see Funds struggle to beat the market – a 'know-nothing' investment.

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From Mayer's book 'Intelligence offers the ability to identify investment opportunities, temperament provides the courage to buy them, and patience the ability to hold them'. And according to Mayer (and others such as Buffett), patience is the rarest of the three.

Lack of patience can also be seen in the annual Dalbar study that reveals that the average investor earns much smaller returns than the managed funds that they are invested in (which usually earn a lower return than the markets they are in). In 2014, the study reported that this gap was 8% less than average Fund performance, which is quite substantial and over the long term compounds to a substantial underperformance. So investors are often their own worst enemy producing even worse returns because of the tendency to buy and sell their investments, making poor decisions in the process, that are often driven by emotion.

And at this point we should bring in the media and brokers. Both parties may be essential and well meaning but they have incentives to make investors act or react to news. Good news and bad news will often see a flurry of activity as investors chase what's moving rather than sitting on an investment that has gone nowhere for a while and with which they have lost patience or got bored. Investors (humans) crave activity and Wall Street depends on it. Making investment decisions for non-investment reasons such as price movements or news headlines is fraught with poor outcomes.

As investors, we need to accept that prices will vary more in any given year than the underlying value of the business, and we should seek to profit from that not become victims of it. In summary, this is why we seek quality companies to own for the long-term and why the turnover in the Fund is very low by industry standards.

Portfolio Changes

During the quarter, we added to our holdings in Reece Australia, Nick Scali and Beacon Lighting. All three companies exhibit the long term qualities we seek and have grown their businesses substantially.

Beacon Lighting produced a great result last year with sales up 19%, profits up 43% and the design and development of 440 new products. They have followed up with another record profit in the latest half with sales up 8%, profits up 22% on the previous year, and the design and development of 205 exclusive new products. The company generates returns of more than 25% on assets and 30% on shareholders equity, and with 91 stores in existence and the potential for 130 stores it still has plenty of room for further growth.

Recently they commenced a new division, Light Source Solutions, following the purchase of the licence rights to sell GE globes in Australia and New Zealand. GE have decided they wish to concentrate on commercial lighting rather than consumer lighting, hence the opportunity. The GE licence will allow the company to move into the hardware and retail sectors of the market through distribution of GE globes through such sites as Bunnings, Coles and Woolworths. Philips is the main competitor and while the margins on this part of the business will be lower we see this as further evidence of management's ability to seize opportunities to grow the business.

After a few years of finding growth hard to attain, **Reece** have also produced a good half year result following the acquisition of Actrol, with revenue rising 8.7% and profits growing by 12%. Similar to Beacon the company has a very conservative Balance Sheet but should still produce a return on equity of nearly 20%.

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In something of a surprise, given the maturity of the business, **Nick Scali** reported a 32% increase in sales and 41% in profits during the half year. The company opened two new stores during the half but also managed to achieve same store sales growth of 11.6%, which is an excellent result.

A metric worth following with retail businesses is that of gross profit margin and on that score Beacon Lighting and Nick Scali both shine as they both achieve gross profit margins of more than 60%. A gross profit margin indicates the difference between the price paid for the goods by the company and the price paid by the customer. Generally speaking, the higher the gross profit margin, the more highly valued the product is by their customers and demonstrates a competitive advantage of some degree. Focusing on gross profit margins as opposed to net profit margins also helps distinguish between competitive advantage of the product, and managerial ability in running the business, although clearly they often linked in the best performing companies. And the more sustained the gross profit margin, the more durable the competitive advantage.

With major family controlled shareholders at the helm of all three businesses we are confident that they will prove attractive investments over the long-term so long as we deliver patience as fellow shareholders from our end.

<u>New Addition to the Portfolio – Clydesdale Bank</u>

While we tend to search for good quality businesses with attractive metrics we are also open to the investment opportunities of buying a dollar for 60c. This does not happen often but we believe we found one such opportunity during the quarter with the addition of **Clydesdale Bank** to the portfolio.

Clydesdale Bank is a regional bank with 2 brands (Clydesdale and Yorkshire) and 275 retail branches in the north of England. Originally founded in 1838 and 1859 respectively, NAB purchased the business in 1987 but couldn't make a decent return and recently spun it off to NAB shareholders. The investment thesis is relatively simple with the bank being spun off at 0.6 times book value in an environment where regional banks usually sell for closer to 1 times book value, with the prospect of underlying profitability restored to more normal levels within the industry. However, there is a reason for the discount. The bank itself has been poorly managed and does not earn a return that covers its cost of capital, it has made some poor quality lending decisions in the past, and has lacked strong leadership and direction in the market.

New management has been installed in the past 12 months with the goal of improving efficiencies and reducing the cost base of the business. Their publicly stated goals are to increase return on equity from its current 5% to a double-digit return which will require an improvement in the cost-to-income ratio from the almost appalling current rate of 75%. Management is targeting 60% within 5 years. The assumption of hitting these targets is not without risk, but these targets only represent the average within the industry rather than trying to outshine its competitors. In other words, management only have to get the bank operating at an average profitability and it should be worth about 50% more than the current price. In addition, NAB has capitalized the bank well and transferred some of the troublesome commercial loans off the balance sheet to further reduce the risk for shareholders.

With limited downside and potentially 50% upside over the next few years we believe there is a lot to like and that this will be recognised by the market over time.

We thank you for your ongoing support and trust this updates further helps investors understand our investment objectives as well as our investment approach when managing the portfolio.

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