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September Quarterly Report

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Market Returns and Portfolio Performance

After the volatility of the June quarter following the Brexit fallout, the September quarter has provided a reasonably sanguine experience for local investors with the local currency remaining strong, commodity prices rising in some sectors and interest rates remaining low.

The All Ordinaries produced a flat result for September of 0.4% and despite various patches of volatility over the past year, has generated a healthy return of 14% over the last twelve months. As always, we encourage investors to adopt a longer term timeframe than this when considering their investment returns and strategies, especially as much of the recent market performance has come from strong returns in the resources sector, which is both volatile and mostly unpredictable.

Performance 30-September-16	Ganes	All Ord Index
1 Month	0.55%	0.40%
3 Month	9.95%	5.30%
6 Month	13.81%	9.51%
1 Year	17.67%	14.01%
2 Year (p.a.)	9.72%	6.69%
3 Year (p.a.)	7.38%	6.42%
5 Year (p.a.)	11.61%	11.04%
10 Year (p.a.)	7.02%	5.18%
Since Inception (p.a.)*	7.81%	6.18%
NAV Unit Price ($)	1.5620	
Fund Assets ($ million)	28.67	

* Inception date of Fund 18/11/2005

We are pleased that despite our lack of exposure to this recent resurgence of resources, the Fund has reported a one year return of 17.7%, outperforming the market by 3.7% over the past year. However, as we are prone to often repeating; short term results are as much as about good luck as good management. To illustrate this point, our largest holding **Smartgroup** has more than quadrupled since our purchase less than 18 months ago. While we believed at the time we were buying this business at a very attractive price, our expectations for such an outsized return over the short term were not predicted by us, or anyone else. In recent times, other fund managers investing in smaller companies would have enjoyed and can recount similar experiences.

Over our preferred 5 year and 10 year time frames, where skill is much more evident than luck, we are pleased to report that the Fund continues to outperform the market. Over 5 years the Fund has produced an 11.6% return against a market return of 11.0%, and over 10 years the Fund return of 7.0% has outperformed the market return of 5.2%. It is important to note that the Fund returns are net of all fees and transaction costs, whereas the market returns are based on hypothetical portfolios and do not bear any fees or transaction costs.

Top 10 Portfolio Holdings	
Smart Group Corporation	9.03%
ARB Corporation Limited	8.32%
CYBG PLC	6.44%
Magellan Flagship Fund Limited	5.86%
Cochlear Limited	5.63%
Flight Centre Travel Group	5.24%
Beacon Lighting Group	4.87%
Adelaide Brighton Limited	4.87%
Nick Scali Limited	4.84%
AUB Group Limited	4.62%
Other holdings	40.28%
Total	100.00%

Confusing Portfolio Activity and Productivity

Turnover in the Fund has always been very low by industry standards. Indeed some months we may not even buy or sell any shares. If investors were to receive a statement with a list of all the transactions undertaken by the investment manager rather than this Fund update, they might be tempted to think we spend more time on a golf course or lying at a beach than in the office. By contrast, industry statistics indicates that the average manager fails to hold most of their investments for even 12 months. Some investors may be tempted to believe that these managers are doing a better job, or at least are more erstwhile in their endeavours, but we believe in this industry investors shouldn't confuse the busyness of trading activity for being productive.

We like to take a long term perspective. Indeed some of our investments like **ARB Corporation** have been held for more than a decade delivering a return of 23% per annum for shareholders over that timeframe despite the GFC. In this case, allowing the outstanding performance of the business to deliver results to shareholders as patient shareholders has proven the best strategy. Hence our thoughts are that if an investment manager can't find a business that they are happy to own for at least a few years (especially as their financial models probably make predictions for 10 years and sometimes 20 years), then the person most likely benefitting in that relationship is the broker, rather than the investor.

We prefer to measure our productivity by how we have added to our knowledge base of the way the world works, and more particularly, how the businesses within the portfolio are performing and looking for new companies that might be added to the portfolio.

Reading constitutes a large portion of most days, along with critical thinking and talking with others about companies and prospective investments. We endeavour to not confuse the activity of buying and selling with being productive. This 'slow' style investing is well suited to our temperament and investment of goal of finding of good quality businesses that can grow over time and reinvest capital at attractive rates of return. The best thing we can do in these circumstances as investment managers is remain patient shareholders and benefit from the growth of the business and in the process save unitholders the transaction costs and the taxes.

Reporting Season Wrap

It is pleasing to again report that the portfolio had a good reporting season with many companies continuing to grow both their top-line sales and profits and this has been reflected in the strong relative performance of the Fund return over the last quarter.

There were more than 20 companies in the portfolio which reported either half-year or full-year results, but as the largest holdings do most of the 'heavy lifting' in terms of generating Fund returns, we provide an update on the results of the top five holdings below These investments account for 35% of the overall portfolio at the end of September.

Smartgroup delivered another strong result for the latest half-year which has underwritten the share price performance in recent months. Revenue was up 36% to $61m and NPAT up 45% on prior year to $18m. The major portion of this growth came from its recent acquisitions of Autopia and Selectus. The company now has 185,000 salary packages under administration but following the acquisition of Selectus, this will move to more than 210,000, almost double that of June 2015.

The business remains incredibly profitable with an EBIT profit margin of 41% and this could improve further as economies of scale from recent acquisitions are bedded down. For example, management is expecting $6m of synergies from the Selectus business and stated these are progressing ahead of schedule. With such strong profit growth, the company also announced a 24% increase in the dividend over the prior year.

The company expects to report a full year profit of between $41m and $43m for the full year, or 38c per share, placing the company on 16.5 times full-year earnings, and with the prospects of growth of more than 20% per annum for the next year or two, the price still remains reasonable despite the strong rise over the past year. In fact, a director with an already significant shareholding has been a buyer of the shares on multiple occasions over the past few weeks, another positive for sign for shareholders.

ARB Corporation produced yet another record result with net profit after tax up 7.6% to $47.4m. Sales increased by 8.2% to $356.9m with exports up 12.6% continuing the trend of the past decade which follows the deliberate strategy in recent years of increasing its distribution capacity in overseas markets, notably the Middle East and northern Europe. Export sales now make up almost a quarter of company sales.

After many years of double-digit growth, and excellent returns for investors, this year's results have been impacted by an unusually high number of new vehicle releases which made it impractical to supply a full range of accessories in a timely manner, as well as constraints on after-market fitting capacity limits. This was flagged in the half-year result in May and management have stated they are addressing the issue. Given their track record and their significant ownership stake in the business, we are prepared to accept this.

With 56 ARB stores in Australia and 3 to 4 more stores expected to be opened this year, and new warehouses both in Australia and overseas it has been a particularly capital intensive time for the business but we believe this expenditure could be setting the platform for further growth. The company depends on car manufacturers regularly updating their models and has exposure to countries where a lower oil price will have some impact on sales as well as the challenge of a higher Australian dollar, but this company has always faced various challenges and found ways to navigate these cyclical conditions.

The total return of 34% for investors over the last year was well ahead of profit growth and the stock looks expensive on any metric, but profit growth from its investments in distribution and manufacturing capacity over the next 2 to 3 years should see the underlying business catch-up with the share price.

We have held ARB in the portfolio for more than a decade, during which time it has delivered a return of 23% per annum to shareholders, and continue to see it as a core holding into the future.

Clydesdale Bank was added to the portfolio earlier this year following the NAB spinoff and we wrote about the investment in our March update. After only a few brief months of ownership we were sitting on a handsome return but Brexit and the collapse of the UK pound quickly dashed most of those returns. Market ructions aside, the underlying investment thesis of a cost recovery exercise under new management has continued to play out as we expected.

The bank recently reported its third quarter trading update and this remained in line with expectations and prior guidance. Indeed, some of the cost savings may be achieved earlier than expected, which will be a positive outcome for shareholders. On the down-side, continuing lower interest rates in England following Brexit will affect net interest margins on loans and make life tough, and should the UK pound remain weak against the dollar this will also have some impact on short term reported earnings but both of these factors should prove cyclical rather than permanent. We believe the downside on this investment still remains low with some potentially attractive returns if management meets their targets.

Magellan Flagship Fund is a listed investment company which we have held for a number of years that holds a portfolio of international stocks rather than an operating business. Accordingly, the financial results of the company are not particularly worthy of comment. However, it is worthwhile noting the composition of its portfolio and the movement in its Net Tangible Asset (NTA) per share over the year. After some stellar returns in prior years the NTA has fallen by 5% over the past 12 months to September. Although, the increase in the Australian dollar from 70c to 76c against the US dollar has more than accounted for this fall. There is very little turnover in the underlying portfolio, which we like, and the portfolio has a significant weighting toward large US based financial institutions with the three biggest being Visa, Wells Fargo and Mastercard. These are high quality, world class businesses that we are happy to be part owners of.

Magellan tends to run a concentrated portfolio with the top five holdings accounting for around 50% of the overall portfolio. The portfolio is unhedged and so investors in MFF are also fully exposed to changes in the Australian dollar relative to the currency of the stocks in the portfolio, which has hurt performance for this year but should become a tailwind again at some stage.

Cochlear also reported a good result with revenue up 23% to $1.2bn and profits up 30% to $189m, and the company predicting further double-digit growth for 2017. Implant growth was 12% with the company selling over 30,000 units for the year, and service revenue increased 30% which is predicted to be a growth engine for the company in coming years with 450,000 life time clients already.

Cochlear is a truly global company and all geographic areas recorded solid business growth sales in the Americas up 29%, Europe and Middle East up 13% and Asia Pacific up 31%. One of the competitive advantages of the business is the amount the company invests in product development and for this year, the company spent $143m (which was fully expensed in the results) on R&D, which represents 12% of revenue.

When seeking long term investments for the Fund profitability margins rank highly in the process. This is because it tends to indicate the company's products which provide value to its clients as well as having some pricing power which generally flow through to the owners of the business in attractive investment returns. On this score, Cochlear remains one of the better ranked companies within the portfolio and the 2016 result continued the trend with the operating profit margin increasing slightly to 22.7%.

Pleasingly for investors, the company announced an upgrade to its profit forecast to $210-$225m, which is 10% - 20% increase on this year. However, in the search for growth in a low growth environment, this has meant the shares have been pushed up to a point where the future return may not be as attractive as the past returns unless the company can outperform even these lofty targets.

<u>Current Activity and Outlook</u>

With the Fund fully invested across a wide variety of industries and the companies within the portfolio generally performing quite well, we remain confident about the future prospects for the portfolio over the medium to long term.

As in previous years, the Fund will pay a distribution for the quarter. The September distribution is 0.6 cents for the quarter.