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December Quarterly Report

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

GANES INVESTMENT MANAGEMENT PTY LTD
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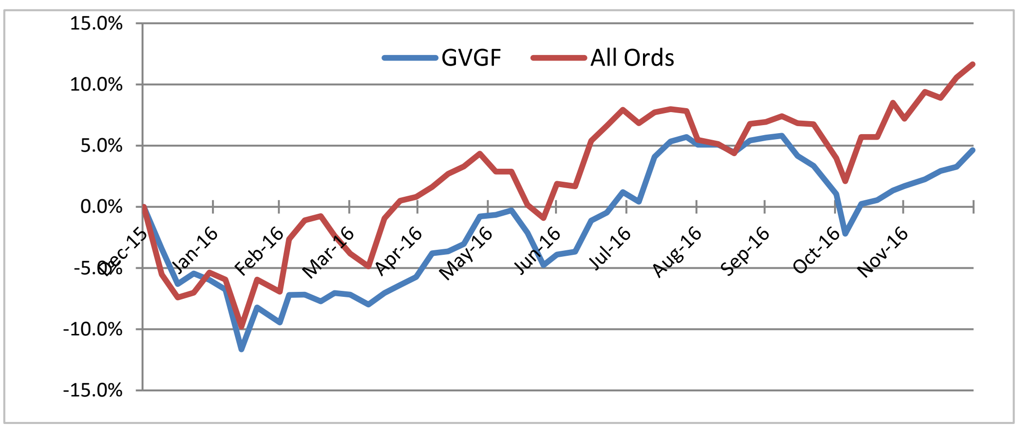
As the chart shows, 2016 has been a roller-coaster ride for the Fund and the broader market. The big slump in January and February, driven by worries for global growth on the back of slumping commodity prices, was largely forgotten by May. Then came Brexit in June with the Fund suffering collateral damage through several UK exposures including **Clydesdale Bank**, **GBST** and **Flight Centre**. The Fund then enjoyed a good reporting season in August out-performing the market by 5.2% for the month.

Performance 31-Dec-16	Ganes	All Ord Index
1 Month	2.88%	4.17%
3 Month	-0.95%	4.41%
6 Month	8.91%	9.94%
1 Year	4.64%	11.65%
2 Year (p.a.)	8.31%	7.64%
3 Year (p.a.)	6.45%	6.76%
5 Year (p.a.)	11.16%	11.59%
10 Year (p.a.)	5.66%	4.51%
Since Inception (p.a.)*	7.54%	6.45%
NAV Unit Price ($)	1.5373	
Fund Assets ($ million)	27.89	

* Inception date of Fund 18/11/2005

The big surprise for the last quarter of the year was the election of Donald Trump and the subsequent market reaction. The expert consensus expectation was a Clinton win and in the unlikely event of a Trump win for the market to fall sharply. Well, the experts were wrong on both counts and the large cap stocks led by financials have pushed the broader market higher over the last quarter. Smaller companies, to which the Fund has a significant exposure, were left behind in this rally illustrated by the fall of 2.5% in Small Ordinaries Index over the final three months of the year against a rise of 7.9% in the largest 20 companies.



Year	GVGF	All Ords
2005	0.5%	3.0%
2006	28.5%	25.0%
2007	7.2%	18.0%
2008	-38.0%	-40.4%
2009	38.8%	39.6%
2010	13.5%	3.3%
2011	-2.5%	-11.4%
2012	19.9%	18.8%
2013	17.3%	19.7%
2014	2.8%	5.0%
2015	12.1%	3.8%
2016	4.6%	11.7%

The end product of the full year then is a gain of 4.6% for the Fund against 11.7% for the All Ordinaries index. A glance at the top ten holdings of the Fund, reveals a portfolio quite different from the underlying Index, with Cochlear, Adelaide Brighton and Flight Centre the only top ten Fund holdings also in the S&P/ASX100 Index. Therefore, it is not surprising that Fund performance will be quite different from the Index in any given period, exemplified by the 7.0% under-performance this year following the 8.3% out-performance last year (see accompanying table). It is also important to note that the Fund performance numbers are net of (after) all fees and transactions costs, whereas the index bears no such burden as it is a hypothetical portfolio with no costs.

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Portfolio review

Currently, the largest ten holdings in the Fund account for 59.4% of the portfolio, which is at the higher end of the historical range. Naturally, these usually represent our best current ideas. However, we also tend to incubate other attractive prospects outside the top ten and let them grow into larger positions through additional purchases as their management teams prove themselves and, hopefully, as the share price increases through business performance. Let's have a look through these top ten holdings.

ARB has been in the portfolio since the early days of the Fund, being added first in February at $2.79 per share. We talked in detail about the merits of this company in the update a year ago, and we are clearly admirers of the management of this business. Over time, many other investors have also become admirers of ARB and the consequent rising share price and associated valuation metrics challenged our comfort around value for investors. Consequently, we did sell a sizable portion of our holding a few years ago below current levels, although some of those sales were motivated by reducing the large exposure that the Fund had to ARB at the time. In our experience, the sell decision is one of the most challenging tasks for an investor, and our philosophy is generally to let stocks that have experienced a strong rise in the share price remain in the portfolio, even if we find the current valuation challenging. As we have seen with ARB, quality businesses, given time, are able to grow into their elevated share price. ARB generated a total return of 11.3% for the year.

While salary packaging company **SmartGroup** had a strong 2016 with a total return of 26%, it was one of the main contributors to the weak final quarter for the Fund, down 12.7% over that period. The underlying business reported a strong first half result in August with revenue up 36% and profit up 45%, with much of this growth coming from its recent acquisitions. The business remains highly profitable with an EBIT profit margin of 41% and this could improve further as economies of scale from recent acquisitions are bedded down.

Clydesdale Bank was added to the portfolio early in 2016 following its spin-off from the NAB. We outlined our thesis for the stock in the March 2016 fund update, so won't repeat that here but the thesis remains. We purchased the current position at an average of $4.04 in early 2016. The share price finished the year at $4.82, but has been held back by the sharp appreciation of the Australian dollar to around 60 British pence currently from around 52 pence in March.

After several stellar years, **Magellan Flagship Fund** suffered a rare year of underperformance in 2016. Magellan is a listed investment company holding a concentrated portfolio of large US listed companies such as Visa, Bank of America, Home Depot and MasterCard. The pre-tax net tangible assets started the year at $2.102 and rose during the year to finish at $2.215 indicating that the portfolio eked out modest gains for the year. At the same time the share price fell from $2.10 to $1.92 – a fall of nearly 9%. We should note the $2.215 does not take into account the tax liability on capital gains which takes post-tax asset backing to $1.891 per share, nor does it take into account the potential dilution from listed options which expire in October of 2017 - which would slice another 11.6 cents of the post tax asset backing. At current prices, we remain comfortable with holding this well managed portfolio.

Furniture retailer **Nick Scali**, was a stand-out performer in 2016 generating a return of 50%. In August, the company reported sales up 30% for FY16 with like for like growth of 11.1% and after tax profit up 53%. We like businesses where management have significant shareholdings in their companies, and Managing Director Anthony Scali now has a 27.3% stake in the company. In late November, the company announced profit for the first half of FY17. It is expected to be 30%-35% above the first half of FY16, which will be a remarkable achievement.

Bionic ear maker, **Cochlear**, generated a strong return of 30.6% for the Fund during 2016. In August, the company reported strong full year results with implant unit growth of 12%, sales up 23% to $1.16b and profit up 30% to $189m. At the same time, the company provided guidance for net profit to be up 10%-20% in FY17. This business generates strong cashflow and boasts modest debt levels. At the heart of this business is market leading technology which must be continually enhanced, and is achieved by spending more than 12% of the business revenue on research and development.

Concrete and aggregate manufacturer **Adelaide Brighton** managed a total return of 20% for the year after reporting a modest 1.2% increase in revenue and 6.6% improvement in profit for the first half of the year in August. This is an old economy business but one that underpins vital construction activity across Australia. However, we are mindful of the elevated multiple the company currently trades on following two strong years of share price improvement.

It has been a more difficult year for the Fund's holding in **Beacon Lighting**. Starting the year at $2.09 the share price fell sharply in May to around $1.20 when the company released a trading update with a forecast for sales and profit well below market expectations. The company cited a range of drivers for this outcome and was a reminder to all investors in retail enterprises, that it is a very competitive industry with limited visibility around futures sales activity. However, we were also aware that it was always going to be tough for management to produce strong growth in 2016 following a very strong 2015 when sales grew 19% and pre-tax profit grew 38.6%. Given this, and our confidence in management, we added to our position in May at $1.26 and by year end the share price had recovered to $1.56.

Flight Centre is a long-standing investment for the Fund. We first purchased the stock in early 2006 around $11 and held it through the depths of the GFC when the price went under $3.50 briefly. For many years now, there have been a number of vocal critics of the bricks and mortar retail travel business model that is at the core of this company, as online travel services continue to grow. Despite that, the value of travel products and services the company sells has continued to grow, benefiting from the relentless fall in the cost of travel and the extra demand that this stimulates. However, there is growing evidence of the business margins succumbing to competitive pressure and much of that competition is online. We significantly reduced the weighting of the stock in the portfolio in 2015 and while we admire what Graham Turner has achieved building this business, we think that the time has come to further reduce this position. The share price slid from $39.89 at the start of the year to $31.30 at the end resulting in a negative return of -17.7% for the year.

Insurance Broker, **AUB Group**, managed a very solid 20.6% total return for the year, following two negative return years as the insurance sector suffered a period of premium compression. Industry conditions and premiums now appear to be improving which bodes well for the underlying business.

In the update a year ago we reflected on what worked in the portfolio, what didn't work, and what lessons were learned. The top ten company reviews above highlight a lot of what worked, that is, being invested in dynamic smaller companies that sell products and services that their customers want and value, and that have motivated, invested, capable managers. These are the type of companies that we like and continue to search for – though, as Flight Centre demonstrates, the underlying economics can change for even the best businesses and investors need to remain vigilant to determine if this has occurred.

In a reversal of what worked last year, the exposure to overseas businesses through three listed investment companies, hurt Fund performance this year. We have already noted that **Magellan Flagship Fund** generated a negative return for the year, after several years of strong returns. Other LICs in the top ten at the start of the year were **Templeton Global Growth** and **PM Capital Global Opportunities**. Templeton managed a 3.3% total return for the year while PM Capital Global was flat. In a parallel vein, international fund manager, **Platinum Asset Management**, suffered a negative 30.7% total return for the year driven by a material fall in funds under management, with weak absolute and relative fund investment performance likely contributing to outflows.

While only a small overall loss was realised on the Fund's terminated investment in **Isentia**, it made a significant negative contribution to the 2016 Fund performance. The position in Isentia was sold when we lost confidence in management following a trading update where the company announced that the King Content business purchased for $46.8m just over a year prior, would make a shock loss in the first half.

We continue to hold a positive view on the prospects for the businesses we own in the portfolio and look forward to reporting back to you on their progress. We thank you for your continued support and would like to wish you a prosperous 2017.