GANES

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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

Market Returns and Portfolio Performance

Markets

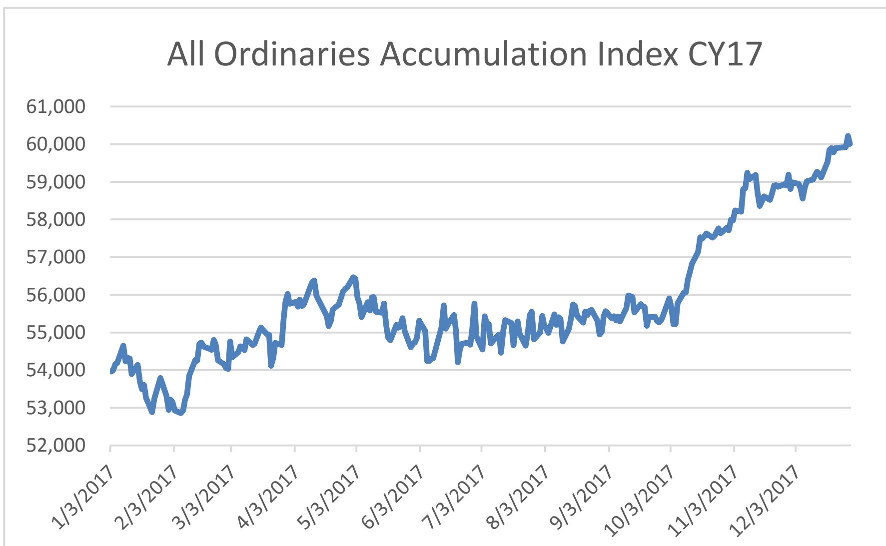
Performance 31-Dec-17	Ganes	All Ord Index
1 Month	0.35%	2.03%
3 Month	10.36%	8.20%
6 Month	17.69%	9.31%
1 Year	22.85%	12.47%
2 Year (p.a.)	13.38%	12.06%
3 Year (p.a.)	12.96%	9.23%
5 Year (p.a.)	11.69%	10.37%
10 Year (p.a.)	7.11%	4.01%
Since Inception (p.a.)*	8.73%	6.94%
NAV Unit Price ($)	1.8375	
Fund Assets ($ million)	28.61	

* Inception date of Fund 18/11/2005

The past year has delivered one of the better returns in recent years with the All Ordinaries Accumulation Index (which includes dividends), up 12.5% for the year, although this pales against the performance of overseas markets where almost every market rose more than 20%, with emerging markets the standout performer.

After a long period of delivering high returns, the banks had a subdued year with most recording negative returns during 2017 and Telstra performing even more poorly falling 30% for the year. Last year, the large cap sector led by the banks, had pushed the market higher while smaller companies had been left behind. This year that outcome was largely reversed with many smaller companies producing stellar returns for investors. In some cases these returns were warranted, but in recent times there are quite a number of companies, particularly in the technology sector, where it could be argued that current valuations can only lead to disappointment for investors over the coming years.

The hardest hit sector was retail, with the overall sector falling 13% for the year on the back of the entry of Amazon into the Australian market. Apparel companies were particularly hard hit and the industry saw many private companies forced into liquidation along with public company failures such as Oroton and Specialty Fashion hitting hard times.



Fund and Stock Performance

The Fund has reported its best year since 2009 with a return of 22.9% for the year. Our lack of exposure to the previously mentioned banks and Telstra helped, along with the strong performance of a number of our larger holdings which we will elaborate further later in the report.

So much about having a good year is not suffering mistakes and to this extent, the Fund had a good year with less than a handful of companies in the portfolio suffering negative returns during the year. However, much of the short-term return is more indicative of market sentiment than our stock picking skills and after a modest year last year, small companies were back in favour and the Fund was the beneficiary of this sentiment.

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Our stockpicking skills are more accurately reflected in our longer term results (over 5 years), and we are pleased to report that we have outperformed the market over time frames (1, 3, 6, 7, 8, 10 to 12 years), even after payment of all fees and expenses.

Year	Fund Return	Market Return	Outperformance
2017	22.9%	12.5%	10.4%
2016	4.6%	11.7%	-7.1%
2015	12.1%	3.8%	8.3%
2014	2.8%	5.0%	-2.2%
2013	17.3%	19.7%	-2.4%
2012	19.9%	18.8%	1.1%
2011	-2.5%	-11.4%	8.9%
2010	13.5%	3.3%	10.2%
2009	38.8%	39.6%	-0.8%
2008	-38.0%	-40.4%	2.4%

<u>Quality suits our temperament</u>

To the lay person investing is likely a matter of buying shares and hoping they go up. However as with any skill, there are many facets and Fund managers can generally go down various paths to achieve their objectives. We have long advocated buying quality companies rather than any other path – that is not to say it’s the most successful, but that it more closely matches our temperament as investors.

We have generally found that good quality companies provide the least headaches to their shareholders, a more predictable future, and the ability to remain long term shareholders in a successful business accessing compounding returns.

Quality businesses have generally created a competitive advantage in their market over many years and this competitive advantage is usually hard to destroy quickly, providing attractive returns for shareholders. However, companies with little or no competitive advantage and no pricing power tend to provide miserable long term results for shareholders and management become adept at providing a never-ending array of excuses as to why the current results are poor but next year’s will be better. At various times these types of companies will become so cheap, or market conditions will temporarily change creating some short term favourable trading conditions, that they offer attractive returns.

However, investors need to have both the temperament and the skill to recognise these turning points before they can expect to achieve good investment results. For many, however, they can also be what are known as ‘value traps’ where the business always looks cheap and eventually the poor underlying economics of the business come to the fore again and investors earn poor returns in tandem with the business. We have long recognised that this style of investing does not suit us and hence why the portfolio consists of what we believe are ‘quality’ companies. While they can sometimes appear expensive in the short-term, we have usually found that the business value catches up to the share price and will often provide a favourable surprise along the way.

Four wheel drive components manufacturer **ARB Corporation** is a classic example of this type of business within the portfolio. It rarely ever looks ‘cheap’ but it has grown profits and achieves a high return on equity with little use of debt and shareholders have received a 22% per annum return for the past decade, while markets have provided a 4% per annum over the same time frame.

Why we like businesses with founders or Capital Allocation versus Management skills

Another feature of our investment strategy is that we prefer companies with founders still running the business, or closely involved. Why is this?

Apart from the fact that the founder has obviously already been very successful getting the business to its current position, we believe founders make better capital allocation decisions for shareholders.

Running a business requires the usual management skills of marketing, production, staffing etc. but what is rarely evaluated is management’s capital allocation skills – that is, how do they allocate the capital retained within the business on behalf of shareholders. Over the long term this is very important. It is the essence of creating wealth for shareholders.

To illustrate this concept consider a company with $100m in shareholders equity and it earns 15% return on its equity and pays out 50% of after-tax profits as dividends, that is management retains $7.5m of capital each year to either buy another business, invest in plant & equipment, pay down any existing debt or buyback shares. In the space of a decade, absent any changes such as raising more capital, increasing bank debt or issuing any shares - shareholders equity will more than double to $206m and current management will be responsible for the capital allocation decisions of roughly 50% of all the capital deployed in the business at that time.

So no matter how long a business has been in operation, if management retains just 7.5% of shareholders equity from profits they will be responsible for more than 50% of the capital deployed within the business in just a decade from now. Hence why we assess this skill when evaluating businesses for the portfolio. Poor capital allocation decisions through ill-advised acquisitions, issuing capital too cheaply, or investment in unproductive assets are intrinsically linked to long term investment returns. Done poorly, it is the shareholders who wear the cost, not the management.

Portfolio Review

Currently the largest holdings in the Fund account for 70% of the portfolio, up from 60% last year. This has increased because of the strong performance by some of our larger holdings, most notably **Smartgroup** and **Gentrack**, the exercising of options in **MFF Capital**, and increasing our holding in **PWR Holdings**.

It was a very positive year for the Fund, with eight of our top ten holdings generating double-digit returns. The standout performers were Smartgroup and Gentrack both up more than 80% and Cochlear up more than 40%, while the worst performing stock in the portfolio was Collins Foods, down 14% for the year.

Smartgroup has enjoyed another good year and has been the strongest performer in the portfolio since purchase in mid 2015 and is the largest holding in the Fund due to its price appreciation. The company’s business is salary packaging and novated leasing for employees of generally large government departments and not-for-profit organisations. During the year, it made some further tuck-in acquisitions which has enabled it to gain synergies through overlapping of various clients as well as diversify its client base. The company recently released a trading update stating that profits are expected to be up 45% on the prior year.

Gentrack was also added to the portfolio in mid 2015, and a stellar 85% return for the year has launched it into the top five holdings. Gentrack is a New Zealand based company that provides billing software for electricity, gas and water utilities and airport management software for airports. Much of this share price increase came following the acquisition of their major competitor in Europe, greatly increasing their product offering to the utilities market in the UK. And this has shown through in their results with additional clients, new contracts, and the expansion into South East Asia leading to revenue rising 43% (18% excluding acquisitions), and profits up 54% for the year.

MFF Capital Investments generated a 16% return for the year which is roughly in line with US returns after adjusting for the stronger Australian dollar during 2017. In a positive sign, the investment manager, Chris Mackay, increased his direct investment in the Fund during the year to 11.3% of issued capital, with a value of approximately $135m. In addition, Mr. Mackay adopts a strategy of investing in quality global businesses with strong competitive advantages which aligns with the investment strategy of the Fund. Its largest holdings remain Mastercard, Visa and Home Depot which are unique businesses not available to local investors. We added to our holding through the exercise of options that we had held for a number of years, which expired in October.

The share price of **PWR Holdings** was static for the year but that doesn't reflect the progress or potential of the business. Currency movements affected profits and masked the underlying improvements being made within the business. With a more stable currency environment and a rejuvenated F1 competition under its new owners the future, results for PWR should look much better than that of 2017. Led by founder Kees Weel, we believe PWR with its mission critical cooling equipment and lack of competitors in its niche areas provides the company with excellent pricing power and the opportunity to continue to earn very attractive returns on capital. We added to our position when the share price temporarily weakened during the year and we foresee PWR remaining a core holding within the portfolio for many years.

Outlook

With the strong performance of the market for the year, and with little prospect for a rise in interest rates, it seems fair to conclude that at current levels, the overall market appears neither particularly cheap nor expensive. We are not finding bargains but volatility within individual stocks which usually provides opportunistic moments to deploy capital as was the case with PWR during 2017. We also believe that should the Australian dollar weaken, some our companies should report higher profits from the currency tailwind, particularly MFF Capital, PWR Holdings and Cochlear which generate almost their entire earnings overseas.

We remain optimistic about the future prospects of the portfolio of businesses held by the Fund and this continues to be reflected in the fully invested position of the Fund. The portfolio comprises a mixture of companies with motivated and innovative managers, good revenue and profit growth potential, as well as strong balance sheets and healthy cash flow.

A distribution of 0.9959 cents per unit has been paid to unitholders on the register at December 31, making a total of 1.566 cents per unit for the half year.

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