16 August 2012

Ganes Value Growth Fund
Investment Manager's Annual Letter 2012

Note: The following commentary is prepared by the Manager of the Fund, Ganes Investment Management, and represents the views of the Manager.

Dear Unitholder,

The 2012 financial year has been another volatile and difficult period for investors. For a third successive year the European sovereign debt crisis has remained unresolved and weighed heavily on market sentiment, and it still appears a long way from resolution. In the US, there have been signs of life with some improvement in activity and unemployment but with official interest rates near zero that is the least that might have been expected. US corporations have very strong balance sheets and are earning historically high profit margins which tend to make the US stockmarket look cheaper than it actually is. Here in Australia, the picture is hazy. While we have avoided recession, have just 5% unemployment and interest rates around their long term averages, there is a sense of unease about what the future may bring. News of European debt woes, a stalled US economy, a slowdown in China, falling commodity prices, local job losses, a struggling retail sector, sliding house prices, very high household debt and political instability have Australian consumers and businesses reluctant to spend or take risks.

Given this environment and a minus 7% return for the S&P/ASX All Ordinaries Accumulation Index over the 2012 financial year, we are pleased to be able report a positive 5% return for the Fund, representing a strong 12% outperformance on the Index. The adjacent table presents the year by year performance record of the Fund against the S&P/ASX All Ordinaries Accumulation Index, along with the end of financial year cash level and Fund turnover during the year. The table shows that the Fund has outperformed the broader market in five of the last six years and the margin in the last four years is material, particularly given the Fund performance is net of all fees, whereas the market performance does not have the burden of fees.

Performance, Cash holdings and Turnover

FY	GVGF	All Ords	Margin	Cash	Turnover
06/07	31%	30%	1%	8%	
07/08	-24%	-12%	-12%	15%	14%
08/09	-12%	-22%	10%	31%	27%
09/10	23%	14%	9%	14%	14%
10/11	17%	12%	5%	30%	32%
11/12	5%	-7%	12%	31%	16%

This performance has been achieved with quite high cash levels. The high cash level assisted performance in 2008/2009 but has been a headwind in the last three years. Our preference is for cash levels to be much lower than they currently are, but this is an indirect product of our bottom up approach to running the Portfolio. If and when we see attractive investment opportunities, cash levels will fall. The last column in the table measures Fund turnover (as sales during the year divided by the average of the Fund value at the start and end of the year). The long run average turnover of the Fund is around 20%, which is significantly lower than the industry average which on some estimates is close to 100%. Our low turnover approach is deliberate. We like to buy stocks for the Portfolio which we can hold, if possible, for several years. Stocks like ARB which have a track record of conservative management, revenue growth, profit growth and capital discipline are hard to find and once we find them and put them in the Portfolio we are reluctant sellers. The payoff for unitholders includes lower transaction costs and the postponement of capital gains tax, ultimately showing up in higher after-tax returns.

As we did last year, the adjacent table shows the top ten holdings in the Portfolio at the start of the financial year and includes the total return for the year for each company. The top ten does most of the heavy lifting in terms of Portfolio performance, and so it is useful to analyse how these stocks have contributed to performance over the year.

Top 10 stocks as at June 2011

	% of portfolio (June 2011)	Total Return FY12
ARB	6.7%	23.4%
Flight Centre	4.0%	-8.3%
Woolworths	3.9%	1.0%
Austbrokers	3.8%	13.5%
Coca Cola Amatil	3.2%	21.8%
Spark Infrastructure	3.1%	26.0%
IOOF	2.7%	-2.1%
Sonic Healthcare	2.5%	3.3%
Cabcharge	2.5%	4.3%
Computershare	2.4%	-13.3%

The largest holding in the Fund, **ARB**, has put in another rock solid year. We first bought this company for the Fund in early 2006 on the back of an excellent long track record as a listed company. In 2006 the company made a pre-tax profit of $19m. In 2011, it made $51m and this growth has been achieved with almost no debt and very little in the way of acquisitions. The company reported a solid first half this year though sales were impacted by the disruption to the supply of new vehicles from Thailand and Japan. The company is a major beneficiary of the strong trend toward Australians buying 4-wheel drives rather than traditional sedans, and has a strong research and development program to maintain its number one position in this market. A small quantity of shares was sold during the year to reduce its high weight in the Portfolio.

The negative return for **Flight Centre** during the year belies the strong underlying performance of the business. For the first half of the year, the company reported record transaction volumes, revenue and profit and has provided guidance for this to continue for the full year with pre-tax profit expected to be up 16-18% on last year. Significantly, all ten countries where the company now operates are profitable and the company expects to grow its global sales force by 8-10% in the coming year.

The **Woolworths** share price has marked time over the year in line with the underlying business which reported a small increase in revenue and profit at the half year mark. Price deflation and a re-invigorated competitor in Coles has meant that growth is much harder to come by than previously. However, Woolworths remains a high quality business commanding prime geographic locations where millions of Australians shop each week for life's essentials and little luxuries. Reflecting this quality is the 28% return on shareholder equity in 2011. Contributing to that excellent return is the ability to operate with negative working capital. For Woolworths, this means that the business is able to sell its stock and collect the cash, on average about nine days before it has to pay the supplier of that stock.

Insurance broker, **Austbrokers**, had a very good year with a 13% return and a 17% increase in first half profit and upgraded full year guidance of 10-15% profit growth. Insurance brokers earn a percentage of insurance premiums and have no under-writing risk, thus benefiting from premium increases such as those that have flowed through following the natural disasters of the last few years.

Coca Cola Amatil has produced a very good return for the year given how badly businesses exposed to discretionary consumer spending have fared. The ability of the company to produce positive revenue and profit growth in the first half despite a variety of challenges has highlighted the strength of its brands and the resilience of its businesses, and found it new friends.

The top performer for the year in the top ten holding is **Spark Infrastructure**, which is in the dull business of owning and managing electricity distribution networks in Victoria and South Australia. This is a capital intensive business but one where the capital spent earns an attractive, regulated and thus very low risk return. Very few other businesses enjoy that sort of certainty.

We made a decision early in the financial year to sell down the holding in financial services provider **IOOF** due to the significant regulatory and financial market challenges it faces and the absence of revenue growth, and as a result it is no longer a top ten holding. **Sonic Healthcare** also fell out of the top ten mainly due to share price movement. For the half year the company reported modest increases in revenue and profit but off a low base in the prior period. Sonic is now a global business with operations in the US, the UK and continental Europe. The business has grown significantly over the years but the growth has been driven by acquisitions funded with a mixture of equity and debt. Ensuring these acquisitions are successful and produce an appropriate return is a major challenge.

Taxi services and bus operator, **Cabcharge**, generated a small positive return for the year despite producing a good half year result. The company faces major challenges on several fronts including possible regulatory challenges to the 10% surcharge on taxi fares, erosion of its market dominance by competitors and new payment technologies. We are concerned about the long term outlook for the business and have made some small sales of stock accordingly.

The smallest holding in the top ten, global registry business **Computershare**, also produced the worst return and the poorest business performance of the top ten. The falling share price saw it fall out of the top ten. For the first half, profit was down 14% in a tough operating environment where transactional based revenue has been hard hit. At the same time, management revised full year guidance down to negative 10% to 15%, well below market expectations.

There are three new additions to the top 10 holdings this year in **McMillan Shakespeare**, **Cochlear** and **Fleetwood Corporation**. Salary packaging administrator and vehicle lessor, **McMillan Shakespeare**, returns following its absence last year. McMillan was our second largest holding during 2010 but we reduced our holding through 2011 as the price rose strongly reducing our estimate of expected future returns. However, the company produced another strong result for 2011 and we added to our position again in August 2011. In its latest half year results, earnings were up 21% and the dividend was increased by 37%. The company's core business of salary packaging administration continues to perform strongly with revenue up 20% and seems to always surprise us how rapidly they can grow the top line. The company does have some risk such as the reliance on favourable tax regulations for some sectors of the workforce and reliance on government contracts and we are always mindful of this.

Cochlear is a company we have long admired and wanted to own, but have never had the opportunity to buy at prices we thought offered an attractive return. That opportunity arose in September 2011 when the company announced a recall of its implants, after identifying an increase in the number of implant failures, and the share price subsequently plunged. We formed the view that this was a temporary blip rather than a fatal stumble and started buying. Earnings for this year and possibly even next year will not be meaningful as the company will incur significant abnormal costs in relation to the recall, possibly as much as $130m before tax. More important in the short term, will be the company's unit sales to ensure there has been no brand damage from the recall.

Fleetwood Corporation has been held in the Portfolio since 2007, and is an unsung hero. In a market that has gone nowhere for 5 years Fleetwood has provided an attractive 15% per annum return over the same period. While we haven't added to the position since 2010, it moves into the top 10 as a result of price movements. Fleetwood is a diversified company offering prefabricated accommodation for the resource sector, and manufactures and sells caravans under the Coromal and Windsor brands. The diversification in the business appears to work nicely for the company with the strong West Australian resources boom balancing out the lower earnings from the caravan division in the latest results. This has occurred a number of times over recent years where one division has a good year while the other struggles. The company reported a record half-year profit result with earnings increasing by 10% on last year.

Overall, we have been pleased with the general performance of companies within the Portfolio during the past year. However, we have continued to trim the Portfolio during the year and now have 39 holdings, down from 47 at the start of the year.

Once again, thank you for your ongoing support and we look forward to updating you on the progress of the Fund in twelve months' time.

Yours Sincerely

Ganes Investment Management