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Markets

The 2014 financial year was another positive period for investors and one that saw most sectors handily outperform alternative asset classes. With interest rates being held low for some time this has virtually forced investors to equities and property seeking yield. In key overseas markets where interest rates are virtually zero, and it appears they will remain at that level for some time, the impact was even more acute with those markets producing strong returns. Indeed, the US market has hit 22 new record highs so far this calendar year.

The Australian market was up 17% for the year, defying underlying business performance, but spurred on by low interest rates and improved property markets. The banks, which constitute a big sector of our market, were all up around 20% as investors were attracted by the fully franked dividend yield and improved profits on the back of a more buoyant property market.

There is no denying that being a shareholder in an Australian bank has been an enjoyable and profitable experience for the past decade or more. For example, Commonwealth Bank has returned 16.4% per annum for a decade and since the GFC has returned more than 20% per annum. However, it is also noteworthy that our banks are now the most expensive on valuation grounds in the western world and our property prices, which underpin a large component of their loan book, are similarly expensive.

Fund performance

In a world of low interest rates and low inflation we improved the wealth of our unitholders in both absolute and real terms with a 1-year return of 6.4%. However, we underperformed the market that, as noted above, had another good year on the back of strong returns from the banks and large resources companies. We note that our 2.1% outperformance over 7 years means that an investment in the fund is worth around 15% more than a similar investment in the index over the same time frame – small compounding returns provide large benefits to investors over long time horizons.

We have always sought to invest in quality businesses that we believe offer attractive returns over the medium to longer term and as a result the Fund does not replicate the index. As stock pickers, it is inevitable that at times we will underperform the market. We endeavour for that not to happen, but unfortunately it is a part of the investment experience at times and one for which we should be prepared.

Performance 30-June-14	Ganes	All Ord Index
1 Month	-1.91%	-1.41%
3 Month	-1.96%	0.47%
6 Month	0.37%	2.68%
1 Year	6.41%	17.64%
2 Year (p.a.)	14.56%	19.15%
3 Year (p.a.)	11.31%	9.69%
5 Year (p.a.)	14.73%	10.99%
Since Inception (p.a.)*	7.52%	6.29%
NAV Unit Price ($)	1.4456	
Fund Assets ($ million)	42.74	

* Inception date of Fund 18/11/2005

A significant contributor to the subdued return this year has been the high allocation to cash. At the start of the year cash was 43% of the portfolio and 35% at year-end. The return on cash invested during the year was little more than 3%, meagre as it turns out compared to the returns on equities. Our desire is to be fully or nearly fully invested, and so the high cash levels reflect the lack of high quality businesses available at prices that offer attractive medium to long-term returns.

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The table below presents the Fund's yearly returns compared with the market for the past six years. Over the longer term we have outperformed the market, and indeed the 2014 financial year is our first year for six years that we have underperformed the market.

Financial Year	Fund Return	Market	Outperformance
2014	6.4%	17.6%	(11.2%)
2013	23.3%	20.7%	2.7%
2012	5.1%	-7.0%	12.1%
2011	17.0%	12.2%	4.8%
2010	23.2%	13.8%	9.4%
2009	-11.9%	-22.1%	10.2%

Company Specific Performance

Looking more closely at the main contributors to Fund performance during the year, the largest positive contributions in dollar terms (in order of contribution from best to worst) came from **Flight Centre**, **Treasury Group**, **Computershare**, **Woolworths**, **Fiducian Portfolio Services**, **Sonic Healthcare** and **Spark Infrastructure**. Five of the seven companies were in the largest ten Fund holdings at the start of the year and delivered the strong positive contribution by virtue of their weight in the portfolio and double digit returns. Making a strong contribution from outside the top ten holdings was Sonic Healthcare and Fiducian Portfolio Services.

Fiducian Portfolio Services had a stellar year with the share price up more than 60%. This was well ahead of performance in the underlying business with interim revenue flat and profit up due to cost control. The share price performance reflected a clear market re-evaluation rather than improvements in the business. We took advantage of the under-valuation to purchase more at $1.05 early in the year compared with the current price above $1.60. Limiting the contribution to Fund performance was the relatively small weight of the stock in the portfolio reflecting the risk around a business of this size (current market cap $48m). The remaining companies in the list above remain in the top ten holdings at the end of the year and will be discussed separately below.

The largest negative contributions in dollar terms (in order of contribution from worst to best) came from **McMillan Shakespeare**, **Coca-Cola Amatil**, **Trade Me Group** and **Invocare**. McMillan Shakespeare and Invocare were top ten holdings at the start of the year so the negative returns they produced during the year were felt keenly by the Fund.

McMillan Shakespeare

McMillan Shakespeare was our largest negative contributor to fund performance taking nearly 1% off the fund value, however some explanation will demonstrate that the investment has still been a good one for the fund overall. We purchased most of the holding in this stock in early 2008 at an average price of $3.26 when the company was out of favour amid fears around the future of favourable Fringe Benefits Tax regulations under the Henry review. These fears evaporated as the Henry review recommendations were largely ignored and the share price subsequently rose to a high of $18 in July 2013. As the price continued to rise we gradually trimmed our position from 2010 onward, always with the regulatory risk in the front of our thinking. This risk came home to roost in July last year when a policy change announcement by the then Prime Minister, Kevin Rudd, in the lead up to the Federal election, sent the share price plunging from over $18 to $6.75.

The announcement saw the industry stop dead in its tracks and write almost no new business in the 3 months up to the election. The share price recovered to as much as $13 when the Coalition was elected and we took the opportunity to significantly reduce our exposure at an average of $11.30. Overall, from a $1.5m investment we have realised nearly $1.9m in capital gains and still have a small unrealised gain on our position despite the awful outcome this year.

As expected the first half result was significantly impacted by this disruption but indications are that the business has since fully recovered. At current prices, closer to $9, value is more compelling but we are conscious the regulatory risks remain.

Invocare

The reliable growth in the underlying business of the last few years at **Invocare** came to a halt this year with a lower than expected death rate and market share losses evident in the full year result. Invocare runs a very profitable funeral home and crematorium business and has provided shareholders with outstanding returns for over a decade, however the past year wasn't one of them. With the price looking expensive against the company's growth prospects we trimmed the position after the first half result, but nevertheless the fall in the share price over the year has hurt fund performance.

Coca Cola Amatil

After a decade of solid and steady growth the world changed for Coca Cola Amatil during the past 12 to 18 months. Aggressive pricing from its main competitor Pepsi, and pricing reductions sought by the major supermarket chains has caused the company major challenges and resulted in a restructuring and profit downgrades.

Coca Cola had been a solid performer for the fund and similar to many other quality businesses we own and its price had risen strongly over the past few years, doubling in the past 5 years. We took the opportunity to take some profits and halve our position in 2012 as we became concerned about the increasing pressure the company was under, however, it's fair to say we still under-estimated the total impact of these challenges. The company's share price is down nearly 25% in the past year, however, at current price levels we also see more value and have recently topped up the holding.

Trade Me Group

Trade Me Group is the dominant New Zealand internet intermediary between sellers of houses, cars, jobs, general items and consumers and was added to the portfolio during the year. The company earns mouth-watering profit margins courtesy of its dominant position, but growth has stalled in its general items business. The classifieds business (property, cars, jobs) continues to grow strongly with revenue up 16% in the first half. The company is only a recent addition to the portfolio and the share price has fallen since the initial position has established which often occurs as we build a position in a company. The recent price weakness has allowed us the opportunity to add to the holding.

<u>Top ten holdings</u>

Top 10 Portfolio Holdings	%
Cash	35.00%
Flight Centre	9.25%
Woolworths	6.76%
Austbrokers Holdings Limited	5.51%
Treasury Group Limited	4.38%
Spark Infrastructure Group	4.17%
ARB Corporation Limited	3.47%
Computershare Limited	3.32%
Sonic Healthcare Limited	2.85%
Magellan Flagship Fund Ltd	2.61%
Other holdings	22.68%
Total	100.00%

Flight Centre made the strongest dollar contributor to Fund performance given its position as the largest holding in the portfolio (at both the start and end of the year) and a solid 16.7% return for the year, even though it is down 20% from the $55 it reached in just the last few months. The company achieved another record year of revenue and profit for the business and recently announced that it is expecting profits to be up another 8-11% for this year. Despite the growth the price has fallen recently, along with many other companies exposed to discretionary spending. We have held Flight Centre for many years and with another solid year of growth expected in FY15, we are comfortable continuing to hold this company.

Woolworths is a core holding of the portfolio starting the year at number 3 and finishing at number 2 in the portfolio and produced a 11.5% return for the year. Woolworths is somewhat unique as one of two dominant national supermarket chains, boasting world-class profit margins and supported by an almost un-assailable store footprint. It dominates the liquor retail business, well ahead of Coles, but is struggling to get its fledgling hardware business, Masters, viable in the face of the category-killer Bunnings.

Mid single digit growth is on the cards going forward though we believe Masters could provide a significant upside option on this. This growth plus a 3.8% dividend yield indicates an 8-10% total return, if the share price roughly tracks business performance.

The **Austbrokers** share price ran well ahead of the underlying business in the previous financial year rising nearly 60% between June 2012 and June 2013 as the market fell in love with the company. The Fund enjoyed the run having purchased its stake at much lower prices between March 2009 and Feb 2011. We trimmed the holding in June 2013 and again in February this year following a half year result where the company failed to deliver a result above management guidance for the first time in quite a long time. Expense growth had exceeded revenue growth under the new CEO, a slightly worrying occurrence, and something we will monitor closely in the upcoming full year reporting season.

The resurgence in equities market has driven share prices of fund managers including **Treasury Group** higher over the year. Funds Under Management (FUM) at 30 June 2013 was $17.13bn and by March 2014 this had grown 12% to $19.18bn. Scale and the higher margin retail inflows meant that profitability has increased even more. Underlying profit for the first half was up 30% on the prior period and the interim dividend up 35%. We topped up the holding following the first half result and it is now our 4th largest holding.

Spark Infrastructure, the owner of Victorian and South Australian power transmission and distribution facilities continues to chug along satisfactorily earning a decent relatively low risk return on capital. The company has provided distribution guidance for the full year of 11.5c, a 6.1% yield at the current price. This is a 4.5% increase over 2013 and a 4.8% increase over 2012. Guidance for next year is distribution growth of 3-5%. In summary the holding is producing a circa 10% return in a monopoly like asset.

ARB Corporation navigated a difficult year well, as we have come to expect from this exceptionally well managed business, but produced a relatively subdued 9.9% return for the year. The business has been impacted by the struggling resources sector and by generally poor consumer sentiment, leading to a fall in margins and profits in the first half for the first time in many years. Our largest holding for some time, we had significantly trimmed the large holding in the Fund over the 2013 calendar year, concerned about valuation and how the business would fair under much less favourable demand conditions. The recent half year results and accompanying management commentary have reassured us that the company still has good growth prospects and can continue to deliver good returns for shareholders.

The resurgent equities market has also benefited the **Computershare** share price with the price rising 24% for the year and now back above the record price of April 2010, despite the underlying business still treading water. First half revenue was flat on the prior period with profit up due to cost control as subdued capital markets and low interest rates have affected its traditionally most profitable markets. Computershare is a truly global business and has been a large holding of the fund for many years. While there is less value on offer at current prices it offers exposure to overseas markets and profits should increase as business conditions improve.

Sonic Healthcare is another case of where the share price performance outstripped underlying business performance during the year, with low single digit growth in profits contrasted against a 21% return for the year. The company continues to expand overseas and is now becoming a major player in the US pathology market, which may also be the reason for the market's enthusiasm for the company. Sonic started the year outside the top ten holdings but its strong performance has pushed it in to the top ten holdings during the year.

Magellan Flagship Fund delivered a positive 7.1% return for the year. The share price was up 28% in the first half as the Australian dollar fell and the underlying equity portfolio performed well leading the shares to sell at a premium to its underlying Net Tangible Assets (NTA). However, during the past six months the Australian dollar has slightly strengthened and the premium to NTA has evaporated leading to recent share price weakness. This company provides investors some international exposure for the Fund, and while the share price remains approximately in line with the underlying NTA we are content to hold.

Cochlear managed a positive return for the year, albeit a small one, which was a bit surprising given the tough year in the underlying business. We purchased the holding in late 2011 following the announcement of the product recall, after having watched the company for many years but always believing the price was too high. The company has disappointed in its profit results in recent times with various factors causing the disappointment. There is some risk of the company disappointing again in the upcoming results and this would likely be punished severely by the market given the resilience of the share price over the last 12 months. This is still a good company, but it may be that it’s not the outstanding company it once was.

Outlook

The financial year just ended produced strong returns to investors in equities with share price rises generally out-stripping underlying profit movements. Take for example, **Commonwealth Bank** where forecasts are for around a 12% lift in profits this year compared to the 22% return investors enjoyed.

The market looks well beyond current profits in sizing up an appropriate valuation for a business, and share returns over the last year may imply expected improvements in future profits as well as the prospect of a lower interest rate environment which increases suggested asset prices. Alternatively, these strong returns may reflect a downward adjustment in the required return on equities suggesting more subdued returns in future years. Or finally, the strong returns of the last year may simply reflect a market that has got ahead of itself.

Regardless, we continue to look for high quality businesses with good growth prospects that offer attractive medium to long term returns. We use a variety of valuation approaches to assess the attractiveness of those opportunities. And we have used basically the same valuation principles since we started the fund, principles that have seen us outperform the market over the medium to longer term.

While we don’t make market predictions we would suggest that some of the valuations we see in the market today just defy our valuation models and we can't possibly see a scenario where buying the shares at current prices will provide a good outcome for investors. However, value will appear (and perhaps suddenly), with the Fund cashed-up and ready to take advantage of the opportunity when it arises.