JENCAY capital

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Jencay Australia Investment Fund

Quarterly report – 31 December 2013

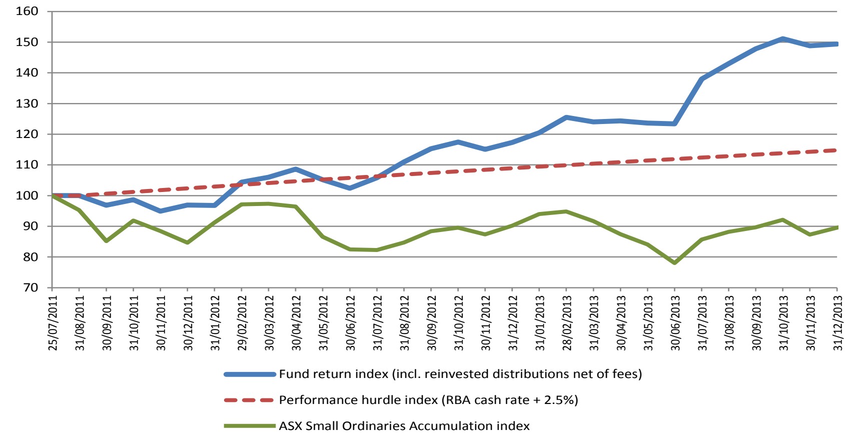
Performance

Returns are net of fees, exclude buy/sell spreads and assume reinvestment of distributions/income	Since inception (annualised)	Latest 12 months	Latest Quarter
Fund total return	**17.9%**	**27.4%**	**1.1%**
Performance hurdle (RBA cash rate + 2.5%)	5.8%	5.4%	1.3%
ASX Small Ordinaries Accumulation Index	(4.4%)	(0.8%)	(0.2%)

Unit Price

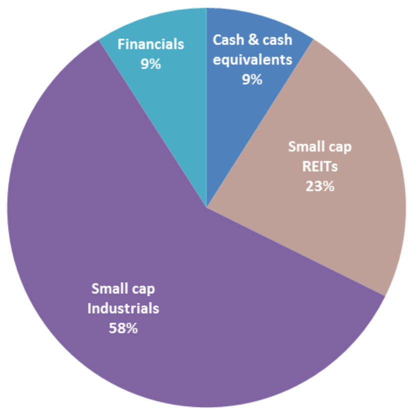
NAV per unit		**AUD 1.40**
Application price	(0.5% spread added)	AUD 1.41
Redemption price	(0.5% spread deducted)	AUD 1.39

Performance Chart



The chart tracks the movement in value of AUD100 invested in the Fund at inception, relative to the Reserve Bank of Australia cash rate plus 2.5% (performance hurdle) and relative to the ASX Small Ordinaries Accumulation index. Returns are net of fees, exclude buy/sell spreads and assume reinvestment of distributions/income.

Fund Composition



Fund size : **AUD 13.1m**

Market returns for the quarter were relatively flat with the ASX Small Ordinaries Index holding steady, the ASX All Ordinaries Index up 3% and the Jencay Australia Investment Fund up 1%. Not much movement has occurred amongst the Fund's top 10 stocks but outside of the top 10, some new positions have been established in stocks that are well below the radar of most managers and priced at levels we believe to be extremely attractive. Mirvac Industrial Trust edged Altium out of the top 10. Surprisingly, the Fund's cash levels are at its lowest point since inception which prompted a more detailed exploration – see overleaf.

Top 10 Positions

Weight %	Name	Summary Investment Case
9	**Cash & cash equivalents**	Approximately three quarters of the cash is held in an ASX listed exchange traded fund whose only asset is a USD call deposit with JP Morgan. The remainder is on call deposit with the custodian, JP Morgan and is denominated in AUD.
7	**Reckson New York Property Trust**	Real Estate Investment Trust (REIT) holding suburban office property in the New York tri-state area. Although RNY is up 70% over the year, it still looks cheap based on a share price that is less than 60% of its Net Tangible Asset value (NTA) and the expectation of some recovery in the underlying property markets.
7	**Australian Vintage**	Australia's second biggest wine producer. The company has emerged from an extremely tough period due to a wine glut and the high Australian dollar rendering its exports (half of its production) unprofitable, despite holding the title of "International Winemaker of the Year" for two of the last three years. The recent drop in the AUD, should help profits rise substantially. Nevertheless, it trades on a P/E of less than 10x last year's earnings.
6	**Enero**	Enero contains the remaining creative, marketing and PR businesses of the failed Photon group. With the group now debt free (in fact more than 1/3rd of the market cap is cash on the balance sheet), new management is pushing hard to restore value and reignite growth in the remaining businesses, many of which are market leaders in their respective fields. Although the share price is up substantially since we initiated the position, significant upside remains.
5	**Thinksmart**	Provider of consumer credit via leading electronics and other retailers. The company recently announced the sale of its challenged Australian business for a price equivalent to its entire market cap prior to the announced sale. The group will be left to focus exclusively on its attractive and growing UK business. Available cash of $48m post the sale compares to the current market cap of $60m,meaning the UK business, which should generate circa $7m in PBT (after taking into corporate overhead) is being valued at $12m.
5	**Austal**	The world's leading aluminium ship builder. It has secured two US Navy contracts to produce 20 ships that will keep Austal's US facility in full production to 2018. The cash flows to be produced from the US Navy contracts alone justifies the current share price with the Australian and Philippine ship yards plus the service business and any future business coming free.
5	**GBST**	Leader in the provision of stockbroking and wealth management platform software in Australia. Many of their products are world class which is driving strong growth in the UK, US and Asia. GBST's share price has more than doubled since we initiated a position less than a year ago and as a result upside has reduced. It now trades on a prospective EV/EBITA multiple of 13x which we believe is still reasonable for a company with GBST's attractive qualities and growth prospects.
5	**Servcorp**	Market leader and world's second biggest serviced office business behind Regus. Founder and CEO owns 50%. 1/4 of its market cap is backed by cash, with no debt. Enterprise value is approximately 5 times our estimate of EBIT in three years' time which is cheap for a company with good management, strong long term growth potential and a large portion of earnings generated outside Australia.
5	**Mirvac Industrial Trust**	REIT holding warehouse property in Chicago. Although the stock has had a good run, assisted by AUD weakness, its share price is approximately 3/4 of NTA. The portfolio is targeted for sale within the next 18 months with proceeds to be returned to shareholders. Any further AUD weakness will be beneficial.
4	**Australian Education Trust**	REIT owning 333 childcare centres spread throughout Australia which it rents out on triple net leases with 9 years of term remaining on the leases. Although the Fund has enjoyed strong returns from AEU, its 2014 expected distribution yield is a healthy 8% which we expect to grow at least in line with inflation.

Risk/Return and the Fund's cash holding

At 9% of the portfolio, the Fund's cash holding is at its lowest point since inception of the Fund. This seems anomalous, especially in light of the strong performance by the Fund and market over the last year (at least for large caps but not small caps). As a result we have spent a lot of time considering whether our cash weighting is appropriate and have come to the following realisations:

1. The cash weight is an outcome rather than a target

What we mean is that if there are sufficient bargains in the market, we will be buying and as a result cash levels could be low. If however, bargains are scarce, cash levels will rise. You may be wondering how it can be possible that we are finding bargains after a strong performance by the Fund. But our sense is that in the very small end of the market, where broker coverage is scarce to non-existent and institutional ownership and liquidity are low, bargains are still available if one looks very carefully. This is in contrast to the big end of the market where values seem stretched after a strong run.

2. The cash weight is not a good indicator of a fund's riskiness

A portfolio is made up of a group of individual companies/stocks/investments (Jencay holds 31 individual positions). Each company has its own unique attributes that impact on the risk and return from investing in that company, which in turn impacts on portfolio risk/return.

Before we purchase any individual stock, we make an assessment of the risk and potential return and only buy when there is a sufficient margin-of-safety i.e. where the trading price is at a sufficiently big discount to fair value relative to our assessment of the risk of the company/stock. Our risk/return framework, which is contained in our Information Memorandum, is shown below:

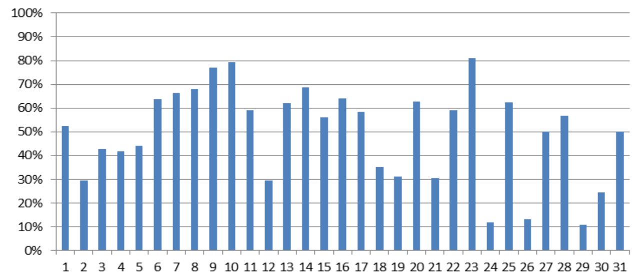
Risk category*	Maximum Acquisition price as % of fair value	Maximum disposal price as % of fair value
Low	65%	100%
Medium	50%	85%
High	35%	70%

*An individual security's risk assessment will take into account liquidity, financial risk and business risk for that entity/security.

Since inception, the Fund has exhibited lower risk than the market (as measured by inter alia volatility and monthly losses) but has still managed to outperform the small cap and large cap index returns. We believe our rigorous risk management framework has assisted immensely in achieving this favourable outcome to date.

A window on the Fund's risk profile is reflected below:

- Out of the 31 stocks in the portfolio, 18 have net cash on the balance sheet (i.e. no debt) and 6 have very low levels of debt. Of the 7 stocks left, 4 are REITs where debt is at about 60% which although appearing high is quite manageable for diversified cash generative property portfolios. Less than 10% of the Fund is invested in the remaining 3 stocks where debt is considered above average. Average debt across the portfolio of stocks is therefore insignificant.
- Price to fair value by individual stock in the Fund, as assessed by Jencay is reflected below. The large discounts to fair value provide a margin of safety that assists with downside protection and return generation:



In summary:

1. **The cash weight is not a silver bullet in assessing fund risk.** A portfolio with low risk stocks and a small cash weight can be significantly less risky than a portfolio with a large cash allocation but full of risky stocks (e.g. volatile stocks or highly indebted companies).
2. **When bargains are available we will continue to purchase them on our unit holders' behalf, regardless of market levels.** Trying to predict future market movement is extremely difficult and therefore a distraction.
3. **Although we are obsessed with managing risk and avoiding loss, the Fund is not immune from short term volatility and capital losses are possible. We believe however that our risk/return framework should protect against losses when measured over the medium to longer term.**

Fund Key Features

Comprehensive Terms are contained in the Information Memorandum which can be downloaded from the website www.jencay.com.au or sent to you upon request

Custodian	JP Morgan Chase Bank N.A.
Administrator	White Outsourcing Pty Ltd
Fund auditor	PricewaterhouseCoopers
Inception	25 July 2011
Investment strategy	The Fund seeks to generate attractive risk-adjusted returns over the long term and protect capital by buying securities trading significantly below fair value (bargains) and holding cash on deposit when bargains are not available in the market. The Fund has a small cap bias in accordance with the Manager's opinion that the majority of bargains are found amongst small caps.
Product type	Wholesale managed investment scheme available to wholesale clients and sophisticated investors
Investment universe	All securities listed on the Australian Securities Exchange (ASX) and cash to be held on deposit
Fund size cap	$200 million in net subscriptions. To manage liquidity the Trustee may limit the quantum of monthly inflows.
Investment restrictions	▪ Maximum of 40 individual securities ▪ Maximum exposure of 15% to a single security ▪ No short positions ▪ No leverage ▪ A maximum of 10% of the fund can be invested in companies with no earnings history such as biotechnology, resource exploration, new technology
Minimum initial investment	$100,000
Minimum additional investment	$20,000
Minimum redemption amount	$20,000
Base management fee	1% p.a. excluding GST. Management Expense Ratio 1.025% p.a. inclusive of non-recoverable GST.
Performance fee	20% of returns above the Hurdle rate subject to a high water mark. The Hurdle rate is the Reserve Bank of Australia Cash Rate Target plus 2.5%.
Entry fee	None
Buy spread	0.5%
Sell spread	(0.5%)
Redemption notice	6 months' redemption notice required otherwise 5% early exit penalty

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