JENCAY capital

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Jencay Australia Investment Fund

Quarterly report - June 2013

Performance

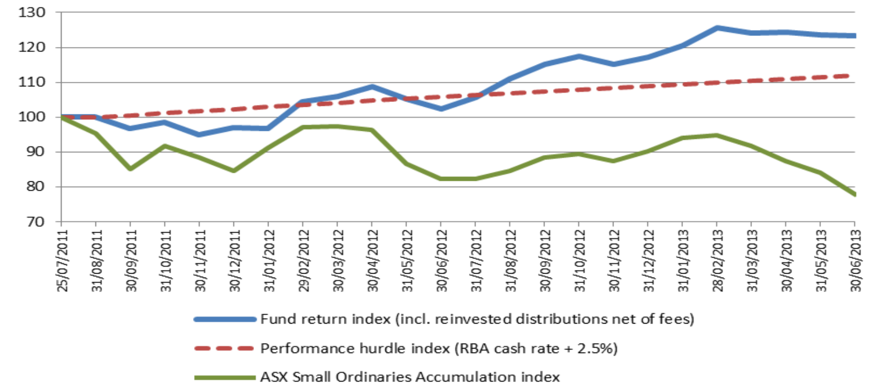
Returns are net of fees, exclude buy/sell spreads and assume reinvestment of distributions/income	Since inception (annualised)	Latest 12 months	Latest Quarter
Fund total return	**11.5%**	**20.5%**	**(0.5%)**
Performance hurdle (RBA cash rate + 2.5%)	6.0%	5.8%	1.3%
ASX Small Ordinaries Accumulation Index	(12.0%)	(5.3%)	(14.9%)

Unit Price

	Cum*	Ex*
NAV per unit	**AUD 1.1922**	**AUD 1.1562**
Application price		AUD 1.1620
Redemption price		AUD 1.1504

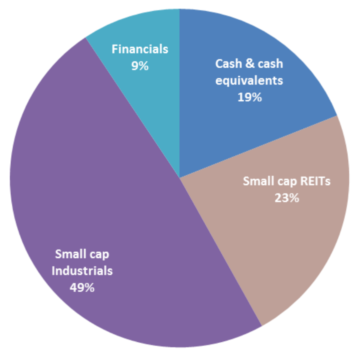
* The Cum price is inclusive of the **3.6c** June distribution. The Ex price is net of the distribution.

Performance Chart



The chart shows 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 9.9m

This quarter was tough for equities and small caps in particular with the overall index (ASX All Ordinaries) down 3.5% and the Small Ordinaries index down 15%. The sharp drop in the Australian dollar assisted in stemming losses for the Jencay Australia Investment Fund (the Fund), which was esentially flat over the quarter. The Fund outperformed due to the combination of its USD cash position and its large exposure to companies with foreign earnings. Multiplex European Property Trust paid a 10c distribution (the stock was trading at 9.6c) and as a result has fallen out of the top 10 positions. Elders was sold after a failed business disposal campaign - it has been a disappointing stock for the Fund but we felt it was appropriate to cut our losses given the significant uncertainty regarding Elders' ongoing viability. Australian Vintage and GBST joined the top 10 positions (see below). The Fund's cash holding increased to 19% due to the Multiplex European Property Trust distribution just prior to quarter end.

Top 10 Positions

Weight %	Name	Summary Investment Case
19	**Cash & cash equivalents**	Approximately 2/3rds of the cash is on call deposit with the custodian, JP Morgan and is denominated in AUD. The remainder is held in an ASX listed exchange traded fund whose only asset is a USD call deposit with JP Morgan.
8	**Reckson New York Property Trust**	Real Estate Investment Trust (REIT) holding suburban office property in the New York tri-state area. Although RNY has doubled in price in just over a year, it still looks cheap based on a share price that is less than 2/3rds of its Net Tangible Asset value (NTA), the expectation of some recovery in the underlying property markets and the imminent completion of its last remaining debt refinancing.
6	**Austal**	The world's leading aluminium boat builder. It has secured two US Navy contracts to produce 20 ships that will keep Austal's US facility in full production to 2018. With the majority of Austal's revenues in USD the stock price has benefitted from the recent AUD weakness. We believe attractive upside still exists based on an Enterprise Value of 5x our estimate of EBIT in 3 years' time.
5	**Thinksmart**	Provider of consumer credit via leading electronics and other retailers. Following a few tough years due to deflation in computer pricing (core product for financing) and a change to a more conservative method of accounting which hit profits in 2012, earnings should now trend back up, assisted by exciting new products and growth initiatives. Although the stock is up 50% since we initiated our position in mid-2012, we believe it still offers good upside, based on a P/E of less than 5x 2014 projected earnings.
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. Servcorp has strong long term growth potential and a large portion of earnings are generated outside Australia.
5	**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. It trades on a P/E of less than 10x last year's earnings even though wine fundamentals are improving and we estimate that the recent drop in the Australian dollar could double profits.
5	**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. Although the Fund has enjoyed strong share price growth from AEU, its 2014 expected distribution yield is approximately 9% which we expect to grow at least in line with inflation.
5	**Enero**	Enero contains the remaining creative, marketing and PR businesses of the Photon group. Photon embarked on an aggressive debt fuelled acquisition spree that almost bankrupted the company. With the group now debt free, 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. The current share price is equivalent to the group's NTA (comprising cash and working capital). Effectively all IP and future profits are free.
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. Distributions recommenced recently. The cycle seems to have bottomed with our expectation that valuations, rentals and occupancy will improve going forward. Any further A$ weakness will also be beneficial.
4	**GBST**	Leader in the provision of stockbroking and wealth management platform software in Australia. Many of their products are world class resulting in strong growth in the UK, US and Asia. Despite GBST's exciting growth prospects it trades on a very reasonable prospective EV/EBITA multiple of 10x. With debt being repaid rapidly, dividends should grow faster than earnings.

Taking the "temperature" of the Australian economy

Although we like to consider ourselves bottom-up investors, renowned investor Howard Marks, from Oaktree Capital (his book "The Most Important Thing" is a classic investment book) believes it is important to take the temperature and understand the environment in which one is investing. We will follow Howard's advice and attempt to take the "temperature" of the Australian economy.

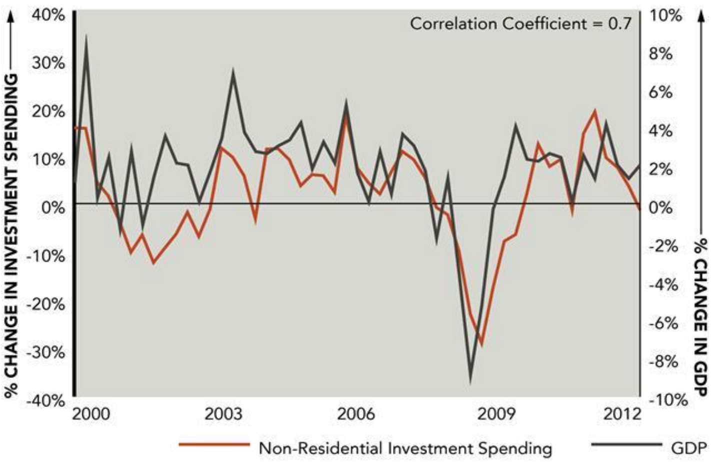
Australia has experienced over two decades of uninterrupted GDP growth. The majority of economic growth over the last few years was driven firstly by a surge in commodity prices followed by booming mining investment. The following information is important in understanding the link between Investment spend and GDP growth:

- Mining capex is currently running at an all-time high of **8%** of Australia's GDP relative to its historic average of **1.5%** of GDP. The reversion to more normal levels of capex will be a big headwind for the economy.
- Mining capex is part of the Business Investment spend component of GDP. Business Investment spend is currently running at circa 15% of GDP, which is high by historical standards.
- The most recent Australian Bureau of Statistics quarterly capex survey suggests the capital expenditure boom has passed its peak and is projecting a **10% contraction in total capital expenditure** for the 2014 financial year relative to the 2013 financial year. In isolation, this would result in a 1.5% fall in GDP (10% of 15%) in the 2014 financial year. The forecasts could prove optimistic.
- The biggest component of GDP, Consumption (Government and Household), which accounts for about 70% of the Australian economy, is remarkably stable. Consumption tends to reduce slightly (not increase) when Investment spending drops due to the negative impacts on jobs and confidence.

During the Global Financial Crisis (GFC), Business Capex dropped sharply in the US which coincided with a deep recession. The chart to the right (courtesy of Marquette Associates) illustrates the correlation of US GDP growth with changes in Non-Residential Investment Spending (Business Investment) over the last 13 years. It is hard to argue there is not a very close link.

Europe experienced a similar fall in capital expenditure during the GFC which pushed it into recession.

Correlation of US GDP growth with Investment Spending



Source: Bureau of Economic Analysis

Unfortunately, the above analysis indicates that Australia is facing recessionary conditions. We are of the view that the probability of a recession is high. The surprising part is that we seem to be in a very tiny minority with that view - only 1 out of 27 economists, surveyed by the Sydney Morning Herald recently, is forecasting a recession for the 2014 financial year. The consensus average forecast is for growth of 2.35%. The Reserve Bank of Australia is projecting 2.5% GDP growth and the Government's Treasury Division is forecasting 2.75% growth.

Be aware however, economists have very rarely predicted recessions in the past (as was the case leading into the GFC in the US). Perhaps economists fear that predicting recessions may lead to one?

We have taken the temperature of the Australian economy and unless our thermometer is faulty, a recession seems very likely within the next couple of years. We believe that recognising this risk allows us to position the Fund to weather the approaching storm. It certainly assisted the Fund in avoiding capital losses this quarter.

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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