Jencay Australia Investment Fund

Quarterly report – 31 March 2015

JENCAY capital
AFS Licence Number 402024
ACN 148810413

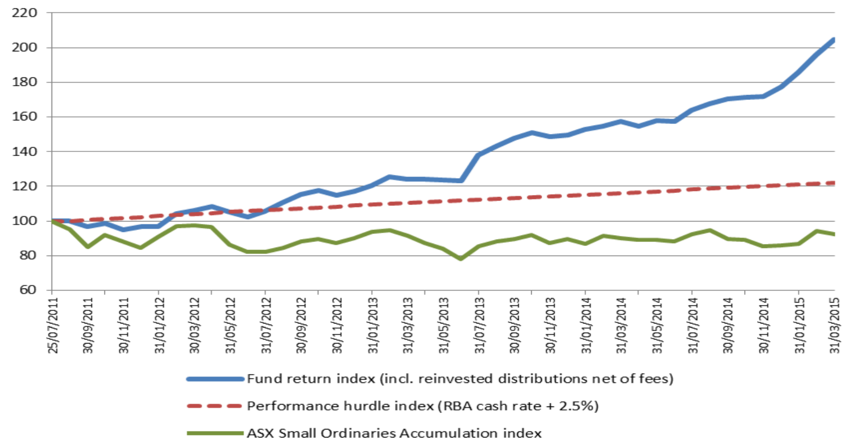
Performance

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	**21.4%**	**29.8%**	**15.4%**
Performance hurdle (RBA cash rate + 2.5%)	5.6%	5.1%	1.2%
ASX Small Ordinaries Accumulation Index	(2.1%)	2.3%	7.3%

Unit Price

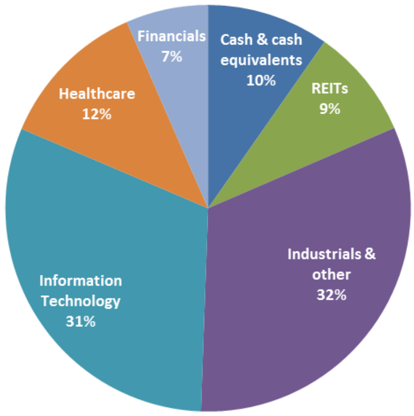
NAV per unit		**AUD 1.8547**
Application price	(0.5% spread added)	AUD 1.8639
Redemption price	(0.5% spread deducted)	AUD 1.8454

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 23.4m**

The fund returned 15% for the quarter in comparison to gains of 10% for the ASX All Ordinaries Index and 7% for the ASX Small Ordinaries Index. Share price performance of individual stocks diverged significantly during the quarter, with those companies that have been growing earnings pulling significantly ahead of those companies where earnings have been flat to declining. We have been actively buying the latter where we are confident that future earnings growth is in store. The divergent price movements have resulted in quite a few changes to the top ten portfolio positions with Integrated Research (previously a top 10 position) plus two new stocks, Aeris and Medical Developments, making it into the list at the expense of Reckson New York, Australian Vintage and Nearmap, all of which are still sizeable in the fund. Longstanding positions, Clearview Financial and Multiplex European Property Trust, were exited to make room for new opportunities following solid contributions.

Top 10 Positions

Weight %	Name	Summary Investment Case
10	**Cash & cash equivalents**	Approximately half 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	**GBST**	Leader in the provision of stockbroking and wealth management platform software. Many of their products are world class which is driving strong growth in the UK, US and Asia. GBST has been a stellar performer for the fund and although upside is not as significant as it was, its share price is still below our assessed fair value based on expected revenue and profit growth, assisted by currency movements.
6	**Pro Medicus**	Radiology software for practice management and remote image viewing. Their world leading radiology image viewing platform is growing strongly. During the quarter they secured another meaningful US client, its 5th significant US client win in the last 18 months. Further comments on the company are contained in the discussion overleaf.
6	**Integrated Research**	Global leader in performance monitoring and diagnostics software for business critical IT infrastructure. 5 of the world's 10 biggest companies use their software. With 95% of revenue generated outside Australia and 50% of costs AUD based, profits are leveraged to AUD:USD movements. The price has almost doubled over the quarter and although now closer to fair value, it is on a dividend yield above 3% (effectively in USD) and still growing strongly.
5	**Thinksmart**	Provider of consumer credit via leading UK electronics retailers. The fund did not participate in their recent off-market buyback tender when almost 40% of shares in issue were bought by the company, as we felt significant upside remains. The business is growing strongly and the buyback will be accretive to remaining shareholders.
5	**Aeris Environmental**	Although Aeris is yet to generate a profit, its innovations in anti-bacterial coatings and materials as well as smart energy are world leading. They have only recently worked out how to commercialise their technology effectively and have a strong pipeline of contracted work that should help to move Aeris to profitability within the next two years. We bought in via a placement in December, at half the current share price. Although valuing the company is difficult, the potential upside is immense and significantly outweighs the downside.
5	**Servcorp**	Market leader and world's second biggest serviced office business behind Regus, with the founder and CEO owning 50%. 1/5th of its market cap is backed by cash, with no debt due to its prolific cash generation. The 3.5% dividend yield should grow in excess of 10% p.a. Attractive for a quality company with good management and a large portion of earnings generated outside Australia.
5	**Galileo Japan Trust**	REIT holding office, retail and residential property in Japan, primarily Tokyo. It is currently trading below its net tangible asset value (NTA) and on a (tax deferred) distribution yield exceeding 8%. The Japanese property cycle appears to have bottomed with evidence that rentals and valuations are starting to improve. In contrast to GJT, Japanese domiciled REITS are currently trading significantly above NTA.
5	**Austal**	The world's leading aluminium ship builder with significant, long term US Navy contracts in addition to its commercial and other military sales. Although we have enjoyed a strong share price performance from Austal, it is still being valued on a low multiple of future earnings and continues to benefit from the weakening AUD.
5	**Medical Developments**	A rare example of a biotech that has been profitable since IPO 11 years ago, and not raised any capital. The company has been selling Penthrox, an extremely effective analgesic (pain killer) in emergency medical settings in Australia for 30 years (it is known as the green whistle, primarily used by ambulances/paramedics). They only recently entered foreign markets, with European marketing approval provisionally granted following successful clinical trials. The company also has a world class asthma spacer, which is growing sales. We began buying just over a year ago and although the share price has doubled, following European marketing approval, we believe successful global expansion can generate further upside.

Investment styles and Valuation

Growth vs. Value investing

Investors that are attracted to companies trading on low multiples (price relative to normalised earnings (P/E) or price relative to tangible net asset value) are typically categorised as Value Investors. Benjamin Graham was the father of this type of investment style which attempts to profit as cyclically low earnings recover or as other investors recognise the inherent value and bid up the price.

On the other end of the spectrum is the Growth Investor, who targets companies projected to deliver strong earnings growth, with the share price expected to follow those rising earnings.

Value and Growth Investing move in and out of fashion. Growth investors suffer when they overpay for companies, especially when earnings growth stops or disappoints. Value investors get caught when a cyclical downturn turns out to be structural and they often miss the great companies that tend to always look expensive based on their multiples, but deliver growth that more than offsets the seemingly high price. CSL (graphed below), Australia's most successful, home-grown biotech company is a great example of a company that most value managers would have avoided because it always "looked expensive".

CSL Ltd – *P/E (blue line, LHS) vs total shareholder return (red line, RHS)*

Source: Iress

Had you invested in CSL when its P/E was its highest in the 10 year history shown above (at 36x in late 2006), your initial investment would be up eight fold over the next 8 years – a 30% p.a. compound return. There are many similar examples of companies that have always looked expensive based on their P/E ratio but proved to be cheap in hindsight, due to the strength of their subsequent earnings growth.

This begs the question - what is a fair P/E?

According to the Dividend Discount/Gordon growth model, a fair P/E multiple is calculated as follows for a company that grows earnings steadily into perpetuity:

$$\textbf{Fair P/E} = \frac{\textbf{dividend payout ratio}}{\textbf{(cost of equity – earnings growth rate)}}$$

Unfortunately the ratio, although very elegant, does not compute if perpetual earnings growth is above the cost of equity or if the growth rate fluctuates over time i.e. it is not a good fit with reality! As a result, the industry resorts to valuation shortcuts (such as industry P/E comparables) that lead to serial valuation inaccuracy (over or under). We believe this partly accounts for the systematic under appreciation for quality stocks like CSL and overvaluation of stocks that never pay dividends.

Our frustrations led us to calculate fair P/E multiples based on discounting expected dividends and a terminal value, over a 20 year horizon. Running sensitivities on the model for the stocks in our portfolio produced some surprising results, one of which is discussed below:

We expect Pro Medicus to grow revenues at about 30% per annum over the next few years based on its superior technology offering and contracts already won. Gross margins on incremental revenues are very high (80% plus) and overheads are quite fixed, which means profits (and dividends) should grow rapidly over the next few years. Based on our assumptions, we calculate that a fair P/E ratio for Pro Medicus is in excess of 100x but it trades on a P/E of 25x next year's earnings.

What the above example illustrates is that companies that can grow earnings strongly, with little capital investment, can distribute all their growing profits to shareholders and are therefore very valuable. It helps to explain why we have not sold some of our best performers that squarely fit into this mould such as Servcorp, GBST, Integrated Research, Altium and Pro Medicus. Although they are not risk-free, they still trade below our estimate of fair value and could be the CSL's of the future.

Jencay's approach

We would prefer not to be boxed in as either a Value or Growth investor because in reality our approach is probably a combination of both. We buy stocks significantly below our estimate of fair value, which could be considered a Value approach, but we have a clear preference for quality companies that can grow dividends, which may be more akin to Growth investing.

In essence, our obsession is with finding stocks to invest in that have lots of upside with low downside.

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 to be applied

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