Jencay Australia Investment Fund

Quarterly report – 31 March 2016

JENCAY capital
AFS Licence Number 402024
ACN 148810413

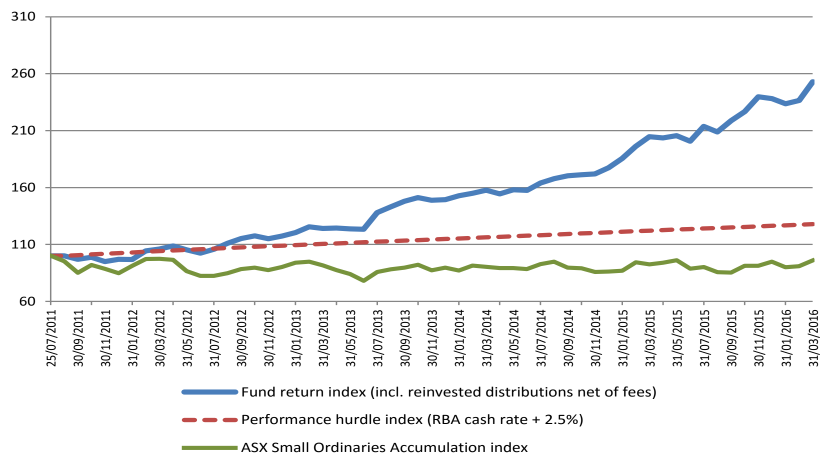
Performance

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	**21.8%**	**23.3%**	**5.9%**
Performance hurdle (RBA cash rate + 2.5%)	5.4%	4.6%	1.1%
ASX Small Ordinaries Accumulation Index	(0.9%)	3.7%	1.0%

Unit Price

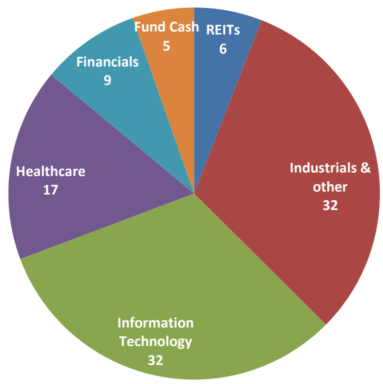
NAV per unit		**AUD 2.164**
Application price	(0.5% spread added)	AUD 2.175
Redemption price	(0.5% spread deducted)	AUD 2.154

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 41.9m**

The 2.5% drop for the ASX All Ordinaries Index and 1% gain for the ASX Small Ordinaries Index during the quarter masked an extremely volatile quarter for equities, currencies and commodity prices, with Australian equity indices down 10% and then subsequently recovering during the quarter due to changing macroeconomic sentiment. The Jencay Australia Investment Fund was less volatile and managed a 6% gain overall. Spicers (formerly Paperlinx) was displaced from the top 10 by Australian Vintage, a former top ten position, following price gains.

Top 10 Positions

Weight %	Name	Summary Investment Case
7	**Netcomm Wireless**	Global leader in wireless communication devices with a focus on the burgeoning Machine to Machine (M2M) wireless Internet of Things. Netcomm has partnered with some of the world's leading Telco carriers and is the sole supplier of rural fixed wireless devices to Australia's National Broadband Network (NBN). AT&T is a significant recent addition to their rural broadband pipeline. We trimmed the position modestly, to make room for new opportunities and to take advantage of price weakness in other stocks.
6	**Medical Developments**	The company has been supplying Penthrox, an extremely effective analgesic (pain killer) in emergency medical settings in Australia for 30 years but only recently entered foreign markets after securing European marketing approval and distribution partners. They are supplying other markets and are in dialogue with the US FDA. The company also has a world class asthma spacer, which is growing sales.
6	**Pro Medicus**	Radiology software for practice management and remote image viewing. The pipeline of opportunity for their world leading radiology image viewing platform continues to grow following 7 significant US client wins in the last two years including a recently announced deal with the large Mercy hospital group. Deal wins continue to justify the growing valuation.
5	**Galileo Japan Trust**	Real Estate Investment Trust (REIT) holding office, retail and residential property in Japan, primarily Tokyo. Management is planning a Japanese IPO of the properties with proceeds targeted for return to current unitholders. The anticipated price, above NTA, would result in the completion of a successful investment for the Fund and its exit from the portfolio.
5	**GBST**	Leader in the provision of stockbroking and wealth management platform software. Many of their products are world class which has driven strong growth in the UK and Asia. With the former head of the Wealth Management division now installed as group Managing Director, we anticipate a return to growth, which is not priced in, for this quality company.
4	**emerchants**	Emerchants is a leading provider of prepaid cards and related technology in Australia and the UK with revenues growing strongly due to its leadership in providing solutions for new and growing market niches including online gaming. The business is extremely scalable with additional revenues largely falling to the bottom line. Just prior to quarter-end a large new contract was secured with one of the biggest online gaming players in Europe, their first in this segment, which bodes well for future wins. Although the share price jumped on this announcement we believe upside could still be material.
4	**Austal**	The world's leading aluminium ship builder with significant, long term US Navy contracts in addition to its commercial and other military sales. The share price has recovered a portion of the previous quarter's decline and further ship orders have been secured from the US Navy.
4	**nearmap**	Using proprietary technology, nearmap captures high resolution images of cities from light aircraft and renders them seamlessly on a subscription based website within 2 days of capture (a more current and clear version of Google Earth). Australian revenues are growing off a relatively fixed cost base with first sales recently secured in the much larger US market. Nearmap's growth and investment is being funded internally by their strong free cash flows which we believe is not adequately reflected in the share price.
4	**Australian Vintage**	Australia's fourth largest wine producer with leading brands in the UK and Australian markets (primarily McGuigan). After a torrid few years characterised by a high AUD, excess wine production in Australia and globally, above market grape and vineyard lease contracts and a poor harvest, the tide seems to be turning with the AUD at more reasonable levels, a significant recent court win allowing the company to terminate a large above market lease and other non-market contracts rolling off shortly. Upside seems significantly greater than downside at the current price.
4	**Thinksmart**	Provider of consumer credit via leading UK electronics retailers. With about 1/3rd of the company's market cap backed by cash, the business effectively trades on an EV/EBIT multiple of only 4 notwithstanding strong growth potential and a recent deal to extend their product range for the Dixons Carphone Warehouse group to mobile phones. An IPO of the European business is being planned, with the Australian listed company to retain the majority share in the business, which may result in its inherent value being recognised.

Why we like being a small fish in a big pond?

In our June 2014 quarterly report we illustrated the superior returns generated by small cap funds over long periods of time, despite the significant underperformance of the small cap index relative to the large cap index. We will explore this in more detail below where we have bucketed stocks into 10 size categories, in descending order of market capitalisation, for the 1000 biggest ASX listed companies:

Analysis of returns for ASX listed stocks ranked by market cap buckets for the latest 12 months

Stock range	Mkt Cap range ($m)		1 yr return (%)					Return range (%)	
by size rank	High	Low	Highest	75th percentile	Median	25th percentile	Lowest	middle 50% of group	Category
1 to 100	124,514	2,357	273	18	2	(11)	(48)	29	Large Caps
101 to 200	2,290	690	806	23	7	(10)	(50)	32	Small Ordinaries
201 to 300	677	326	876	32	6	(15)	(56)	47	
301 to 400	321	172	899	42	6	(15)	(83)	56	Micro Caps
401 to 500	171	98	1,021	30	(2)	(21)	(76)	51	(Jencay's
501 to 600	98	65	1,494	61	4	(28)	(96)	89	prospecting
601 to 700	65	41	736	28	(7)	(27)	(99)	55	zone)
701 to 800	41	30	460	25	(6)	(35)	(100)	60	
801 to 900	30	21	449	71	12	(26)	(85)	97	
901 to 1000	21	16	579	49	(5)	(39)	(94)	88	

Source: Factset data and Jencay workings. Although only 1 year's data given, the pattern is similar in most years. Although over 2300 companies on the ASX, only biggest 1000 included

Our observations from the table above:

- The market cap range for the large caps (top 100 stocks) is $2.3b to $125b. The median return for the group was 2% with highest returning stock in the group up 273%, lowest returning stock losing 48%, top quartile (75th percentile) up 18% and bottom quartile down 11%. It was the first year in many where the large cap median return lagged the small cap median return.
- The 200 stocks comprising the small cap index in Australia i.e. stock 101 to 300 by size, have a wider range of returns than the top 100 i.e. a shorter and wider distribution curve.
- When we drop below the top 300, the return ranges for the next 700 stocks (sometimes referred to as microcaps - our key area of focus) is even wider with some of the best performers returning more than 1000%, worst performers losing their entire value and the range from 75th percentile to the 25th percentile (the middle half of returns) being significantly wider than the top 300.

Implications/Interpretation

The large caps (biggest 100 companies) are well-known, attract lots of media and are very well covered by the investment community. With many parties expressing views on their value, they are very liquid and quite efficiently priced/valued. As a result the range of returns within this group is quite tight. It is therefore difficult for fund managers that invest exclusively in these stocks to differentiate themselves from competitors but their fund size often precludes them from investing in smaller companies in a meaningful way.

As one moves down the list in terms of size, media coverage, liquidity and investor interest reduces. With fewer parties doing detailed analysis and expressing views on the value of these stocks their prices often do not reflect fair underlying value. The wide distribution of returns amongst these smaller stocks reflects this inefficiency.

Notwithstanding the inefficiency amongst the small company universe, median returns are no better than for large caps, and are often worse. This is because there is inefficiency in both directions i.e. some small caps are significantly undervalued and produce impressive subsequent returns whilst some are significantly overvalued and produce horrific subsequent returns. So how then do small cap funds outperform large cap funds and the market indices?

The trick is to focus effort on those stocks that are significantly undervalued as those are the ones that will produce the stellar future returns. There are far more undervalued stocks in the small cap space (microcaps are included in this group) due to the inefficiency described above as well as a bigger pool of stocks to choose from, increasing the odds of outperformance.

Assessing data based purely on averages or medians can be very misleading as it gives no information on the shape of the distribution curve. Large cap returns are distributed more tightly around the mean/median and produce taller, thinner distribution curves whereas the distribution of small cap returns produce wider, flatter curves - it is within the wider curves and fatter tails where the significant opportunities lie. **The small cap tail is significantly larger than the large cap tail and as a result outperformance is far more likely, provided one chooses wisely. We would prefer to be a small fish in a large pond of opportunity than a big fish in a small pond of limited opportunity.**

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
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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Disclaimer

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