Jencay Australia Investment Fund

Quarterly report – 30 June 2016

JENCAY capital
AFS Licence Number 402024
ACN 148810413

Performance

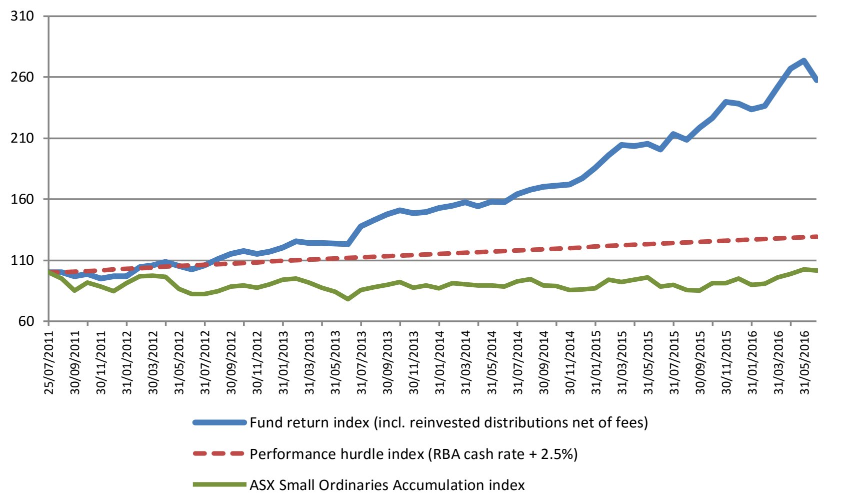
Returns are net of fees, exclude buy/sell spreads and assume reinvestment of distributions/income	Since inception (annualised)	Latest 12 months	Latest Quarter
Fund total return	**21.2%**	**28.8%**	**2.6%**
Performance hurdle (RBA cash rate + 2.5%)	5.3%	4.6%	1.1%
ASX Small Ordinaries Accumulation Index	0.3%	14.4%	5.8%

Unit Price

	Cum*	Ex*
NAV per unit	**AUD 2.220**	**AUD 2.128**
Application price		AUD 2.139
Redemption price		AUD 2.118

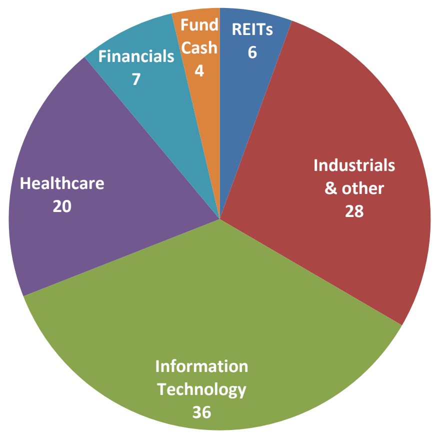
* The Cum price is inclusive of the **9.14c** June distribution. The Ex price is net of the distribution.

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 43.5m**

The market experienced another volatile quarter with strength in April/May reversing in June. The fund, which was up 3%, underperformed the ASX All Ordinaries Index and the ASX Small Ordinaries Index, up 4% and 6% respectively over the quarter. Individual stock performance diverged significantly with some fund stocks holding up well but others, in particular those exposed to the UK, dropped steeply following the exit vote. We were active buyers of the underperformers. The wide divergence in stock performance led to more movement amongst the top 10 than in most quarters with Thinksmart, Australian Vintage and eMerchants being replaced by Adslot (a newcomer, described below), Altium and Integrated Research (both of which have been on the list previously).

Top 10 Positions

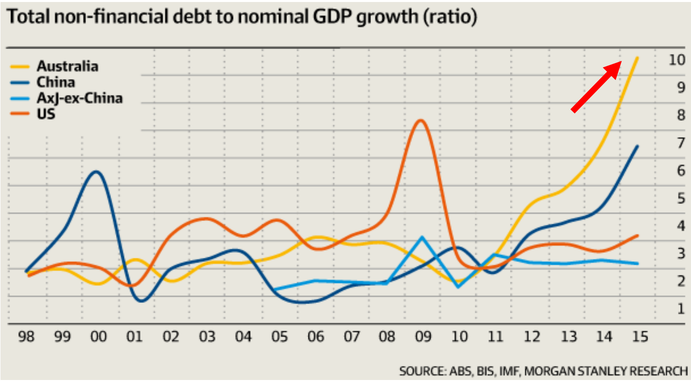
Weight %	Name	Summary Investment Case
8	**Pro Medicus**	The pipeline of opportunity for their world leading radiology image viewing platform continues to grow following 8 significant US client wins in the last two years including recently announced deals with the prestigious Mayo Clinic and Mercy hospital group. Deal wins continue to justify the growing valuation.
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. US FDA approval is the next targeted milestone. The company also has a world class asthma spacer, which is growing sales.
6	**Adslot**	Leading supplier of workflow and trading software, purpose built for the $51b forward guaranteed online display advertising market. As one of the first movers in this space, Adslot is set to benefit from the predicted shift from manual to automated buying in this enormous global industry. We anticipate Adslot will become cash flow positive within the next 12 months based on growing revenues and costs that are largely fixed. Adslot has been in the fund for over a year but emerged in the top 10 following our participation in a recent placement and price gains.
6	**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. The company is investing significantly in its engineering team in order to handle its growing pipeline of work which will suppress profits in the short term.
5	**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 and US sales are building. 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.
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 around September which would complete a successful investment for the Fund.
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. Although less than half their revenues are generated in the UK, the stock price dipped more than 20% around the Brexit vote. We took advantage of the overreaction and topped up our position.
4	**Altium**	World leading provider of computer assisted design software for electronics engineers. Altium has grown revenues at double digit rates for a number of years and has demonstrated good scale leverage by growing costs more slowly. Altium moved back into the top 10 list following relative price strength but still offers reasonable upside.
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 was weak leading into a disappointing profit downgrade just after quarter end, which seems one-off in nature. Their growing construction and service pipeline should result in significantly larger profits in the future.
4	**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. IR re-entered the top 10 after buying on weakness followed by relative price strength.

Taking the "temperature" of the Australian economy……….again

In our [June 2013 quarterly report] we wrote about the importance of "taking the temperature" and understanding the environment in which one is investing based on the sage advice of investment doyen, Howard Marks, from Oaktree Capital. We predicted the likelihood of recession in Australia within 2 years of that report based primarily on the anticipated drop in mining capex from historically high levels. Admittedly we were wrong on our recession prediction - even though mining capex has plummeted as we anticipated, residential property construction, consumer spending and export growth managed to fill the gap.

Although Australia did not experience a recession, as measured technically, **Real Net National Disposable Income per capita has declined by 4% over the last 3 years, according to ABS statistics** (effectively a per capita income recession).

We believe it is a good time to take the temperature again and the following chart prepared by Morgan Stanley and contained in a 30 May 2016 Australian Financial Review article is a good starting point:



The chart above tracks the ratio of growth in debt relative to growth in GDP i.e. how much GDP bang for each buck of new debt are we getting? To grow GDP by $1, Australia is now using $9 of new debt, a level that is above the US during the global financial crisis and even above current levels in China. More and more debt is being required to stoke modest real GDP growth, a worrying development. What happens when debt growth stops? And if debt growth continues at current levels how big a problem are we deferring into the future?

Other concerning recent trends/developments in Australia which will be a headwind to future GDP growth are listed below:

- Credit growth has stalled over the last two months, after macro-prudential lending restrictions were introduced and foreign investor hurdles raised given mounting concern from regulators in regards to the record levels of household debt and rampant house price growth. It will be interesting to see how GDP growth and consumer spending respond to this recent slow-down in credit growth.
- Residential property development and price increases appear to be plateauing at record levels and as a result will contribute very little to further GDP growth. The inevitable reduction from peak levels will detract from GDP in due course.
- Although mining capex has already fallen significantly from peak levels, the most recent ABS quarterly capex survey anticipates a drop of circa $30b from 2016 to 2017 (the biggest drop so far and a potential drag of 2% of GDP).
- March 2016 quarterly GDP grew very strongly at 1% (quarter on quarter) however all the growth came from a jump in export volumes with the other components of GDP essentially flat in aggregate. An export jump of this magnitude will be difficult to repeat and the potential exists for exports to decline if China reduces its coal and iron ore imports.

Apart from employment, which has been resilient so far, we are struggling to find potential positive offsets to the challenges listed above.

The verdict:

Recent GDP growth has relied to a great extent on increasing levels of household debt linked to residential property price growth and residential construction. We believe Australia is bumping up against the upper limits of household debt and residential property prices. Regulators seem to have a similar view and are attempting to turn the taps off.

Our 2013 recession prediction may have been premature but the growth achieved over the subsequent three years was poor in quality (as evidenced by declining income per capita for the country) and came at the expense of ballooning household debt and house prices. We believe the day of reckoning is near.

Our thermometer is guiding us to continue avoiding those sectors exposed to the weakening Australian economy – retail, banks, property, and construction and to persist with our large exposure to companies that earn foreign currency.

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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