

Jencay Australia Investment Fund

Quarterly report – 31 December 2016

Performance

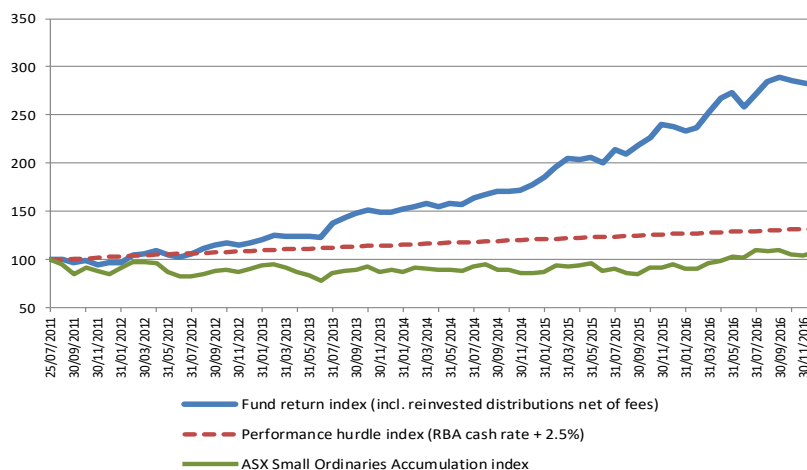
Returns are net of fees, exclude buy/sell spreads and assume reinvestment of distributions/income

	Since inception (annualised)	Latest 12 months	Latest Quarter
Fund total return	21.0%	18.3%	(2.6%)
Performance hurdle (RBA cash rate + 2.5%)	5.2%	4.3%	1.0%
ASX Small Ordinaries Accumulation Index	1.3%	13.2%	(2.5%)

Unit Price

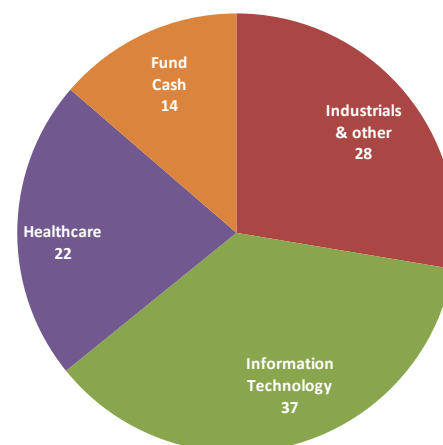
NAV per unit		AUD 2.3186
Application price	(0.5% spread added)	AUD 2.3302
Redemption price	(0.5% spread deducted)	AUD 2.3070

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 60m**

A rotation out of small caps and high P/E companies into large caps resulted in small caps significantly underperforming in the quarter with the ASX Small Ordinaries Index down 2.5% in contrast to a 4.5% gain for the large cap dominated ASX All Ordinaries Index. The Fund dropped in line with the small cap index. High P/E stocks including Pro Medicus, Netcomm Wireless and Medical Developments were victims of the rotation. We were buyers at the lower price levels as company fundamentals have not changed. Nanosonics was displaced from the top 10 by Ellex Medical Lasers, which has been in the portfolio for a year, but entered the top 10 for the first time following strong price gains.

Top 10 Positions

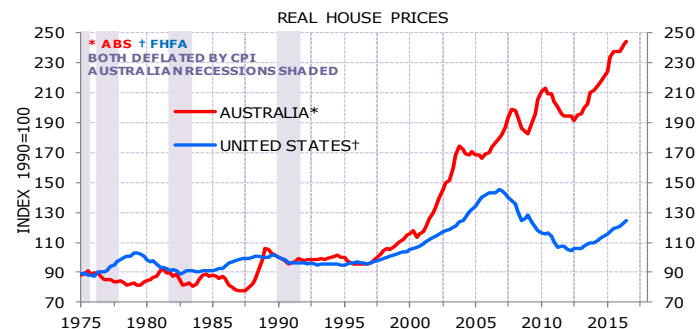
Weight %	Name	Summary Investment Case
6	nearmap	Using proprietary technology, nearmap captures high resolution images of cities from light aircraft and renders them seamlessly on a subscription based website within 2 days of capture (a more current and clear version of Google Earth). Australian revenues are growing off a relatively fixed cost base and US sales are building. A recent capital raise will assist nearmap to accelerate their US growth plans and technology development.
5	Integrated Research	Global leader in performance monitoring and diagnostics software for business-critical IT infrastructure in particular Unified Communications and Contact Centres. A quarter of Fortune 500 companies use their software. We anticipate strong future profit growth due to a shift from perpetual to term licenses and strong product traction.
5	Medical Developments	The company has been supplying Pentrox, an extremely effective inhaled analgesic (pain killer) in emergency medical settings in Australia for 30 years but only recently entered foreign markets. Additional distribution arrangements/approvals were secured for Pentrox and their world class asthma spacer during the quarter. A new partnership with the CSIRO on a novel continuous drug manufacturing process holds promise for applications outside their core products.
5	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.
5	3P Learning	Online learning company, best known for its world leading online maths homework tool called Mathletics which has 4.6m users spread over 20,000 schools across the world. It also distributes Reading Eggs, a popular e-Literacy tool, and has a 40% stake in Learnosity, the global leader in generic online assessment APIs.
5	GBST	Leader in the provision of stockbroking and wealth management platform software in Australia, the UK and Asia. Their biggest UK Wealth client, Aegon, recently purchased Co-funds' and Blackrock's wealth platforms and will utilise GBST's Composer platform to integrate the large acquisitions which should help to grow implementation and license revenues over the next few years.
5	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. Upside has been restored following recent share price weakness.
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. Following a disappointing period, their growing construction and service pipeline is expected to result in significantly larger profits in the future.
4	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). Despite securing another landmark contract during the quarter with the NBN for fibre to the curb devices, the departure of their longstanding CEO and founder contributed to further share price weakness.
4	Ellex Medical Lasers	Ellex is a global leader in lasers used by ophthalmologists in treating a plethora of eye diseases. Innovation is helping Ellex to grow revenues and market share in the traditional established laser business. The company also sells an innovative, FDA approved disposable canaloplasty microcatheter for treating Glaucoma - its leading performance characteristics, recent reimbursement increase and a renewed sales push have the potential to transform the company and is not yet reflected in the share price.

Australia's twin housing bubbles

Negative GDP growth for the September quarter prompts a discussion of house prices and housing construction activity – both key drivers of our economy:

1. House prices

Australia's house prices on almost any metric are amongst the most expensive globally. The chart below, courtesy of Minack Advisors, illustrates Australia's house price movement relative to the US:



The lack of affordability in Australia's housing market is highlighted by the extremely low level of First-time home buying activity and incredibly high level of buy-to-let investment. **First-time buyers in Australia now represent less than 10% of the value of new mortgages in comparison to 20% in the UK, 33% in the US and 25% in Ireland in 2006 prior to their housing crash. Australian buy-to-let Investors are utilising 45% of new mortgages in comparison to 20% in the UK and 25% in Ireland in 2006. The situation therefore looks more extreme than Ireland prior to their 50% price crash.**

Total mortgage debt outstanding in the UK (also considered an expensive housing market) is only 1.5x Australia's despite having 2.8x the population. On a per capita basis, we therefore have almost double the UK's mortgage debt.

The home as an ATM

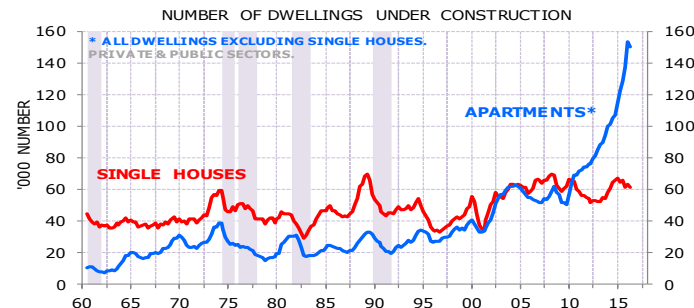
Per the [October 2015 Australian Housing and Urban Research Institute Positioning Paper No. 167](#), every age cohort in Australia, from age 25 to age 64, has been increasing their mortgage debt levels. The increased wealth from rising house prices has prompted Australians to take on more debt to fund consumption or investment - on average Australians increase their debt by \$170 for every \$1000 increase in home values. Booming house prices have promoted exuberant and excessive behaviour – the following recent media articles provide a flavour:

- AFR article on 18 November entitled "Property drives 'supercar boom'" spoke about the record sales year for Ferrari Australia in 2016 with some statistics outstripping even China.
- "Money no object in Noosa holiday rental boom" AFR 15-12-2016.
- "SMSFs heavily invested in property" AFR 16-12-2016 highlighted that 2 in 5 self-managed super funds now hold property as an investment (often geared).

The argument asserted by many when confronted by the extreme facts above (which are not a secret) is that "people have been saying this for years and during that time property prices have continued to climb. At least prices will not drop in the Eastern suburbs (of Sydney)". They have a point but similar arguments preceded almost every crash.

2. Housing construction

Apartment construction has experienced an unprecedented boom as shown by the chart below (source Minack Advisors):



To put the level of housing construction into perspective, Australia is building more than 200,000 housing units (houses & apartments) on an annualised basis in comparison to the US peak of 2.3m units in 2007. The US population is 14x Australia's but US house building in 2007 was only 11x Australia's current level. **We are therefore building more houses per capita than during the US bubble preceding the global financial crisis.** Approval rates for new construction have already started to drop which foreshadows a dip in construction and consequent drag on GDP growth, construction jobs and potentially home prices.

In conclusion

We are extremely concerned by the prospect of our inflated house prices and housing debt colliding with a slowing (potentially recessionary) economy. Although it is impossible to predict when the market will turn and how far it will correct, we are firmly of the view that downside dwarfs any potential upside, warranting extreme caution.

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 most 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	<ul style="list-style-type: none"> 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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