Jencay Australia Investment Fund

Quarterly report – 31 March 2017

JENCAY capital
AFS Licence Number 402024
ACN 148810413

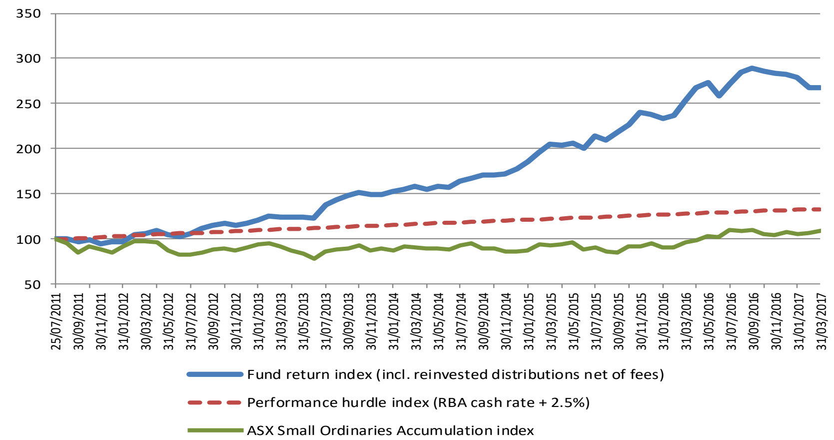
Performance

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	**18.9%**	**6.3%**	**(4.9%)**
Performance hurdle (RBA cash rate + 2.5%)	5.2%	4.2%	1.0%
ASX Small Ordinaries Accumulation Index	1.5%	13.7%	1.5%

Unit Price

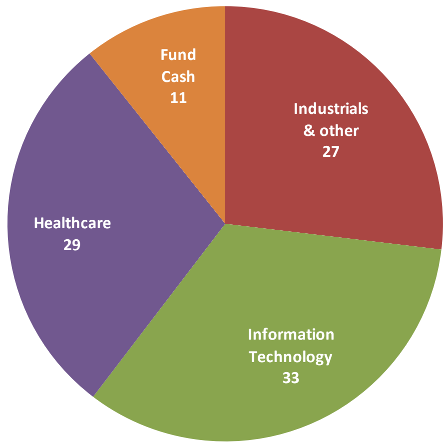
NAV per unit		**AUD 2.2050**
Application price	(0.5% spread added)	AUD 2.2160
Redemption price	(0.5% spread deducted)	AUD 2.1940

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**

The rotation out of small caps and high P/E companies into large caps, resources and value continued during the March quarter. Small caps again underperformed in the quarter with a 1.5% gain for the ASX Small Ordinaries Index lagging the 3.3% uplift for the large cap dominated ASX All Ordinaries Index. The Fund, down 5% over the quarter, underperformed the small cap index due to its large weighting to high P/E growing companies that are currently out of favour. Netcomm Wireless continued its decline and was joined by nearmap, Adslot and GBST. Although some company results disappointed, we believe the price declines were exaggerated by the rotation away from small caps and high P/E companies. Last quarter's top 10 newcomer, Ellex medical lasers, was displaced by Universal Biosensors, a stock we have held for almost two years, described below.

Top 10 Positions

Weight %	Name	Summary Investment Case
6	**GBST**	Leader in the provision of stockbroking and wealth management platform software in Australia, the UK and Asia. A disappointing profit downgrade was issued, due to the weak GBP, delays in client project implementations, and the company's significant investment in upgrading its wealth management platform which should position them well going forward. We believe the share price overreacted to the news, which seems to be just a speed bump, and we have increased our position at these very attractive prices.
6	**Medical Developments**	The company has been supplying Penthrox, 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 Penthrox 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	**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. Some senior management departures may have contributed to a weak share price in the quarter.
5	**Pro Medicus**	The pipeline of opportunity for their world leading radiology image viewing platform continues to grow following significant US client wins in the last two years including the prestigious Mayo Clinic and Mercy hospital group. A large practice management software deal with Australia's Primary Healthcare towards the end of the quarter pushed up the share price following earlier price weakness.
5	**Universal Biosensors**	Holds unique electrode IP that has proven extremely valuable in point-of-care blood diagnostics. Lifescan's market leading One-touch Verio blood glucose analyser utilises their technology for diabetes management. UBI is also the exclusive supplier of the disposable strips used by the UBI designed Siemens Xprecia Stride blood coagulation analyser which was launched recently and is making progress penetrating the market for Warfarin monitoring. UBI is profitable with significant downside protection and almost unlimited upside.
4	**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.
4	**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. Their well-regarded CEO departed during the quarter which was disappointing but the share price held up reasonably well.
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. 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 significant contracts with Australia's National Broadband Network (NBN) and large foreign Telcos and a growing pipeline of opportunities. We topped up our holding following further unjustifiable share price weakness in the quarter.
4	**Adslot**	Leading supplier of workflow and trading software, purpose built for the large forward guaranteed online display advertising market. As one of the first movers in this space, Adslot should benefit from the predicted shift from manual to automated buying. The share price was extremely weak during the quarter with Investor patience being tested by the slower than expected growth in Automated Guaranteed Trading. Revenues are nevertheless growing and we will continue to monitor developments closely.

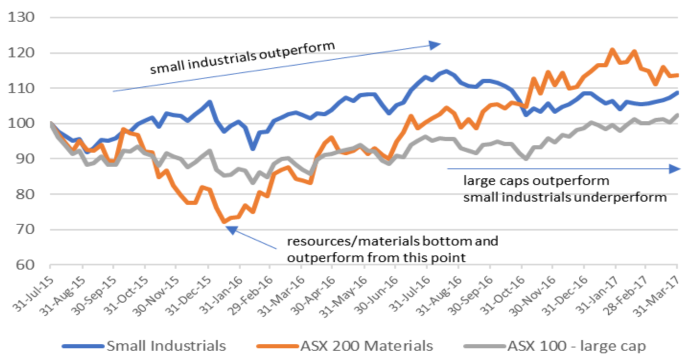
The market is a double-edged sword

The fund experienced its toughest quarter since inception despite the overall market being up. This unwelcome outcome is due to an aggressive market rotation out of small cap, high P/E companies into resources, large caps and value stocks (low price/earnings or low price/book). We will attempt to make sense of this rotation below:

The market over the last two years

During 2015 resource prices were weak and bank stocks drifted sideways with the Australian economy relatively stagnant. Small Industrials started to outperform due to superior earnings growth. Large cap managers (with bank and resource stocks a big part of their portfolios) desperate for performance, shifted some of their exposure into small caps, which drove their prices up further. Small caps, and in particular those with growing earnings, significantly outperformed large caps during that period. The trend changed in August 2016 and since then large caps have been strong at the expense of the small caps.

Resource prices started to rebound in 2016 which pushed up Materials stock prices. The same investors that had recently shifted into small caps were caught flat footed and their underperformance drove them to liquidate their small caps to buy back into the rallying resource and banking sectors. These shifts are illustrated in the table below comparing the relevant market indices over the last two years:



Source: Iress. 31 July 2015 is the common base of 100 for all Indices shown

Flip flopping investment style in an attempt to take advantage of the sector that is the current flavour of the month is an almost certain recipe for long term value destruction. The managers who were late to the small cap party are the same ones that are now late to the resource and banking party, which we believe they will regret. In contrast, we believe it is important to stick to ones Strategy/Investment Style during tough times as the cycle will inevitably turn when one least expects.

Reviewing our portfolio – price relative to fundamentals

We have taken the opportunity to evaluate whether the share price weakness for the relevant stocks in our portfolio was due to deteriorating fundamentals or whether they were merely victims of the rotation.

The following table provides P/E (price relative to earnings) ratios for our top 10 stocks. 2016 reflects the current share price divided by actual earnings for 2016. 2017 through to 2020 reflects the current share price divided by our earnings forecasts for those years:

P/E for top 10 portfolio stocks – current and projected

	2016	2017F	2018F	2019F	2020F	notes
GBST	14	20	9	7	5	
Medical Developments	192	176	85	42	22	(a)
Nearmap	(-ve)	(-ve)	50	16	9	
ProMedicus	86	48	25	17	13	(b)
Universal Biosensors	61	(-ve)	7	2	17	(c)
3P Learning	36	19	14	10	7	
Integrated Research	32	34	21	16	11	
Austal	(-ve)	21	12	10	8	
Netcomm Wireless	79	(-ve)	9	9	10	
Adslot	(-ve)	(-ve)	(-ve)	34	6	

notes
(-ve) : company making losses and its P/E ratio is therefore negative
(a) : Earnings exclude future milestones, any benefits from the CSIRO manufacturing JV or any US Penthrox revenues
(b) : modest level of new business wins assumed
(c) : 2019 earnings are inflated by an anticipated termination lump sum from Lifescan, which impacts on 2020 earnings

The following observations are apparent from the table above:

- Three companies incurred losses in 2016 either due to one-off write downs (Austal), the company investing in costs ahead of revenues (Nearmap), or is yet to hit breakeven (Adslot). 2017 is Netcomm's big investment year. These are often good times to invest provided conviction can be gained in their improvement;
- Three companies (Nearmap, Netcomm and Adslot) will still be in losses in 2017, with only Adslot expected to still be in losses in 2018.
- Although the majority of companies have high current (2016 & 2017) P/E ratios, by 2019/2020 the ratios look far more modest due to strong earnings growth. This gives us comfort that the current share prices are reasonable.

Forecasting (and indeed valuation) is not an exact science and future results will almost certainly be different to our projections. Nevertheless, we are confident that on average the stocks in our portfolio have significantly more upside potential than downside risk over the medium to long term. We are firmly of the view that the weakness in the quarter was a consequence of the shift out of small cap growth combined with overreactions to some isolated bad news and not due to permanently deteriorating fundamentals.

In conclusion – the market is a double-edged sword

Whilst increasing stock or unit prices make investors feel comfortable and secure (and potentially complacent), those growing prices can lead to stretched valuations and less attractive future returns. The converse is also true – declining stock and unit prices feel uncomfortable but help to get prices back to more attractive levels on which to generate better future long term returns. The Fund took the opportunity to load up on those stocks we felt had been mistreated and where we are confident of an improvement. Although we don't know exactly when the pendulum will swing back from large cap/value/resources to small cap/growth, it has been a long time since we have seen such attractive buying opportunities for quality small cap stocks which prompted **the majority of your Investment Committee members to add to their personal investment in the Fund during the quarter.**

Fund Key Features

Custodian	JP Morgan Chase Bank N.A.
Administrator	White Outsourcing Pty Ltd
Fund auditor	PricewaterhouseCoopers
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.
Investment universe	All securities listed on the Australian Securities Exchange (ASX) and cash to be held on deposit
Fund size cap	The fund is now closed to new investors (subject to Trustee discretion) but will remain open for additional investment by existing unitholders
Investment restrictions	▪ Maximum of 40 individual securities ▪ Maximum exposure of 15% to a single security ▪ No short positions ▪ No leverage
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

Contact Details

Trustee and Investment Manager	Web Email	www.jencay.com.au info@jencay.com.au	Tel	+61 2 9238 6177 +61 415 233 512
Administrator	Tel Fax Email	+61 2 8262 2800 +61 2 9221 1194 registry@whiteoutsourcing.com.au	White Outsourcing Pty Ltd Level 3, 99 Bathurst Street Sydney NSW 2000	

Disclaimer