FORAGER

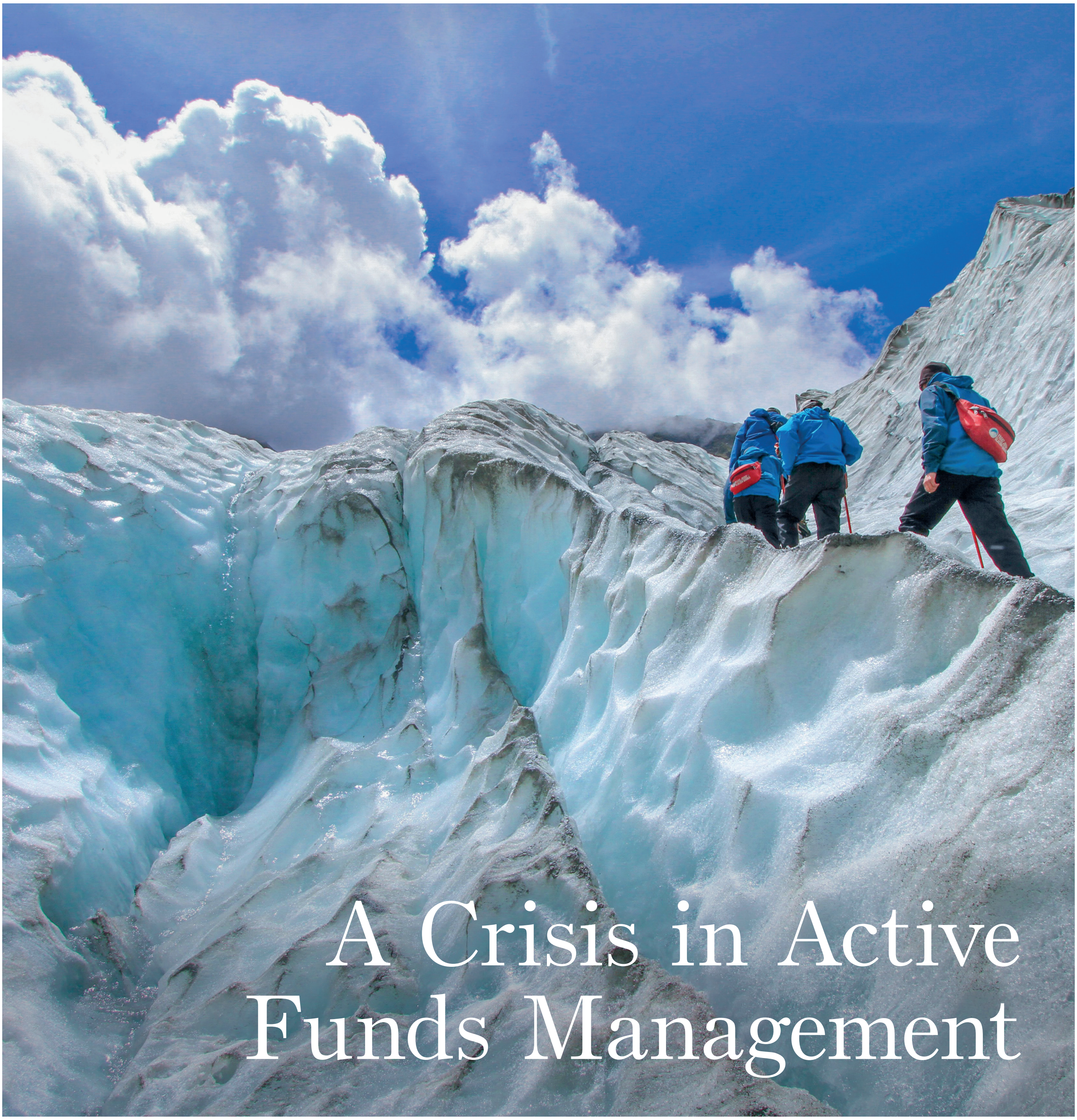
JUNE 2019 QUARTERLY REPORT

AUSNUTRIA'S CASH GOAT IN CHINA
Relative to the world's most expensive growth stocks, it looks like a steal.

AUTOTRADER: PREMIUM BUSINESS, PREMIUM PRICE
Auto Trader will continue to grow nicely, and not via unjustified price gouging.

MAKING A SMART CHOICE
Today, Smartgroup dominates salary packaging alongside McMillan Shakespeare after years of consolidation. Why invest now?

SURPRISING QUALITY AT AN ATTRACTIVE PRICE
Large fleet managers like SG Fleet earn very healthy returns. Once its offering is integrated, switching can be costly and risky.



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VALUE INVESTING: WASN'T MEANT TO BE EASY

Speculative tech stocks are back in vogue. Long-term investing is on the nose. Is now the time to give up on Australia's active fund managers?

The result of the demise of value investing and investor withdrawals has been financial erosion, stressful to us all. And there is no real indication that a quick end is in sight.

And what do I mean by, "there is no quick end in sight?" What is "end" the end of? "End" is the end of the bear market in value stocks. It is the recognition that equities with cash-on-cash returns of 15 to 25 percent, regardless of their short-term market performance, are great investments. "End" in this case means a beginning by investors overall to put aside momentum and potential short-term gain in highly speculative stocks to take the more assured, yet still historically high returns available in out-of-favour equities.

There is a lot of talk now about the New Economy (meaning Internet, technology and telecom). Certainly the Internet is changing the world and the advances from biotechnology will be equally amazing. Technology and telecommunications bring us opportunities none of us have dreamed of.

Avoid the Old Economy and invest in the New and forget about price," proclaim the pundits. And in truth, that has been the way to invest over the last eighteen months.

I have great faith though that, "this, too, will pass." We have seen manic periods like this before and I remain confident that despite the current disfavour in which it is held, value investing remains the best course. The difficulty is predicting when this change will occur and in this regard I have no advantage. What I do know is that there is no point in subjecting our investors to risk in a market which I frankly do not understand. Consequently, after thorough consideration, I have decided to return all capital to our investors, effectively bringing down the curtain.

Don't panic. That's not me talking.

It's famous hedge-fund manager Julian Robertson, announcing the closure of his highly successful Tiger Fund in March 2000.

An early investor in the Tiger Fund made 85 times their money in the two decades prior to its closure. That wasn't enough. A few years of poor performance in the tech bubble led to a wave of redemptions that was too powerful to resist.

It's no coincidence that it has been a full generation but, almost twenty years later, value investing is going through another crisis of confidence. While troubled UK fund manager Neil Woodford might beg to differ, it's a crisis that is particularly severe in our home market of Australia.

In recent months, fund managers including Adam Smith Asset Management, Sigma Funds Management, JCP and Kis Capital have all pulled down the shutters or suffered significant outflows. The ASX has the most expensive growth stocks in the world (see page 6) and, once again, everyone is questioning whether value investing works in the modern economy. Even some of its more loyal advocates are concluding that, no, it does not.

CONCENTRATED INVESTING IS DEAD

This has little to do with the value versus growth argument that has been raging in recent years. While "value" has been underperforming "growth" since the financial crisis, I've written a lot about the stupidity of distinguishing between the two.

Future growth in cashflows is an important component of any business valuation. Value investors should and do buy businesses that grow. Our specialty has historically been investing in underperforming businesses that we think can resurrect themselves. Plenty of successful investors have made their returns finding businesses where the growth prospects are underappreciated. I'd still call them value investors—they are trying to value businesses and buy them for less than they are worth. They are simply using higher valuation metrics because they think the profitability is going to grow significantly.

In today's market, we are all losing out to the speculators.

Here is a list of ASX-listed companies with less than $50m of revenue and market capitalisations of more than $500m. Excluding mining, oil and gas and investments companies, there are 10 on the ASX that meet that criteria. The combined market capitalisation is more than $10bn (that's billion, with a B).

Table 1: Bubble Stocks

Company	Enterprise Value ($m)	Total Revenue ($m)	Net Income Last 12 Months ($m)	12 Months Price Movement	EV/Sales
Avita Medical Limited	755	3	(25)	548%	264
iSignthis Ltd	658	6	(8)	306%	108
Polynovo Limited	951	9	(5)	167%	110
Clinuvel Pharmaceuticals	1,718	27	16	263%	63
Pro Medicus Limited	2,716	45	19	249%	60
Megaport Limited	809	26	(28)	50%	31
Mesoblast Limited	710	23	(127)	-13%	31
Audinate Group Limited	489	25	1	107%	20
Bubs Australia Limited	459	33	(70)	14%	14
Elixinol Global	466	37	(1)	167%	13
Sum/Average	**9,732**	**235**	**(227)**	**186%**	**71**

Source: S&P Capital IQ, Prices as at 25 June 2019

"IT'S NO COINCIDENCE THAT IT HAS BEEN A FULL GENERATION BUT, ALMOST TWENTY YEARS LATER, VALUE INVESTING IS GOING THROUGH ANOTHER CRISIS OF CONFIDENCE."

As a group, these companies lost $227m in the most recent 12 months, so we won't bother with earnings multiples. The average ratio of total enterprise value to revenue is 71 times.

Well done if you owned them a year ago. The 12 month share price movement for this basket of stocks averages out at 186%.

This speculative pocket of the market—there are many more than these 10—is a bubble. I'm happy to be on the record saying that.

Bubbles don't cause sensible fund managers to shut the doors, though. And there is an aspect to this period of underperformance that is meaningfully different to the tech bubble.

This time around, the market rally has also been lifted by a dramatic decline in long-term interest rates and a correspondingly large rally in Australia's dividend-paying blue chips. If you own the index, driven by banks and the large miners, you are also up 20% this calendar year alone.

Index investing is doing well. Speculative gambling is doing well. Is it any surprise that clients are leaving active managers in droves?

UNFORTUNATE SIDE EFFECTS OR ESSENTIAL PREREQUISITES?

Since we started Forager almost 10 years ago, we have told our investors to expect significant periods of underperformance. That's one promise we have delivered on over the past year. The net asset value of the Australian Shares Fund is down from more than $1.82 a year ago to $1.34 today. Factoring in last year's $0.21 distribution, that's a 20% decline in a market that has risen 11%. And the market price that was trading at a premium now trades at a discount to the net asset value, exacerbating the decline for those watching the traded price.

We have made genuine mistakes over the past year. Part of our poor performance has nothing to do with industry turmoil. But periods of dramatic underperformance like this are not just part of investing with us. They are an essential prerequisite to future outperformance.

HARD TO COMPETE IN A RATIONAL MARKET

We have been able to earn decent returns since the founding of our business almost a decade ago, despite a woeful past 18 months. Most of the performance has come in smaller stocks where there is less institutional competition. That's a reflection of the fact that for every buyer who thinks they know something, there is a seller who thinks they know something at least as well.

I'm not willing to back myself in a battle of wits with Julian Robertson. Which is why we have capped the funds under management in our Australian strategy at $200m.

Once in a generation, though, people as smart as Julian Robertson are forced to sell us stocks that they know full well are screamingly cheap. These market dislocations don't just coincide with a loss of faith in value investing. They arise because of it.

We still have 18% cash in the Forager Australian Shares Fund and I want to see it put it to work. There are quite a few attractively priced small caps in the portfolio and we have been adding selectively as the value fallout spreads. What I'd love to find for the remaining 18% cash is some great businesses, preferably larger than the average stock held at the moment, at sensible prices. That would set the portfolio up perfectly for the inevitable recovery and, in its absence, a higher dividend yield than we have today.

As unpleasant as the past 12 months has been, those dislocations are not going to arise without a further loss of faith.

STAFF CHANGES, PERFORMANCE FEES AND A BIG THANK YOU

After six valuable years, Alvise Peggion decided it is time for a change and has moved on from Forager. It was his first job out of university and it is time for him to spread his wings. He will be missed around the office and we wish him the best in his future endeavours.

In June we welcomed another new member to the Forager team. Harvey Migotti joined us as a Senior Analyst on the International Fund and will predominantly be focused on US markets. His favourite idea is already in the portfolio—that's a story for another quarterly report—and combined with Paul Quah's Asian experience, you should expect more new ideas into the portfolio over the coming year (see page 6 for a writeup of Hong Kong listed infant milk formula company Ausnutria).

The first of July also represents the first day of a new fee structure for the Forager International Shares Fund. The base fee has been cut by 0.15% p.a. and a performance fee has been introduced, equating to 12.53% of any return in excess of the index (MSCI ACWI IMI (AUD)). We're aiming for a fee structure that more closely aligns Forager's remuneration with fund performance and think we have struck the right balance. If you are an investor in the Fund, you should have received details via a separate email or letter but please get in touch if you would like more information.

And don't forget our annual roadshow is coming up (dates below). You can ask me all about performance fees, performance (or lack thereof) and the underlying investments in both our portfolios. Call the office or email Nicole on admin@foragerfunds.com if you need any further information. For those who can't attend, we will record the Sydney event and put it on our YouTube channel.

Finally, and most importantly, thank you. It has been a horrible year of fund performance, especially in the Forager Australian Shares Fund. As inevitable as periods of underperformance are, we know that it isn't pleasant as an investor and that we have made some painful missteps over the past 24 months. We are acutely aware that your trust and patience needs to be rewarded over time.

Kind regards,

STEVEN JOHNSON
Chief Investment Officer

FORAGER 2019 ANNUAL ROADSHOW

Perth: Friday 26 July
Brisbane: Tuesday 30 July
Melbourne: Wednesday 31 July
Sydney: Thursday 1 August and Friday 2 August
Performance Report Webinar: Wednesday 17 July

INTERNATIONAL SHARES FUND

FACTS

Inception date	8 February 2013
Minimum investment	$20,000
Monthly investment	Min. $200/mth
Income distribution	Annual, 30 June
Applications/redemptions	Weekly

UNIT PRICE SUMMARY

Date	30 June 2019
Buy price (cum distribution)	$1.5937
Redemption price (cum distribution)	$1.5874
Mid price (cum distribution)	$1.5906
Distribution	5.52c
Portfolio value	$167.4m

CHEAP GROWTH IN ASIA

We love companies that are likely to grow. We just don't like paying up for them. Thanks to Trump's trade wars, widespread pessimism about the Chinese economy and a headlong rush for perceived safe havens, on the Hong Kong stock exchange you can have your cake and eat it too.

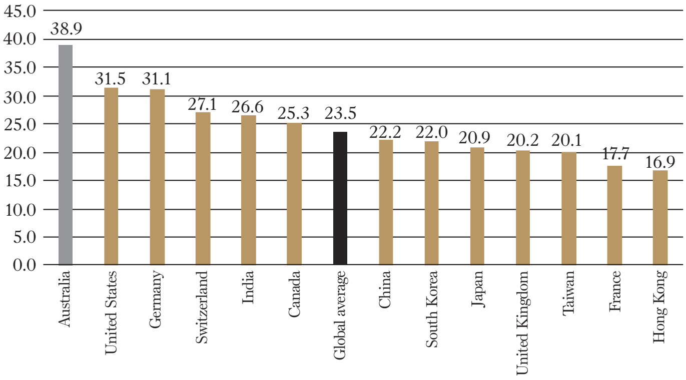
Table 2: Summary of Returns as at 30 June 2019

	FISF (Net of fees)	MSCI ACWI IMI
1 month return	1.85%	5.08%
3 month return	3.87%	4.63%
6 month return	10.21%	16.45%
1 year return	-3.31%	10.09%
3 year return (p.a.)	10.26%	13.64%
5 year return (p.a.)	8.96%	12.51%
Since inception* (p.a.)	12.51%	15.15%

*Inception 8 February 2013
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance.

"Our growth stocks are the world's most expensive" screams the headline in a recent Australian Financial Review article. That's not hyperbole. Goldman Sachs has crunched the numbers and, of the world's 13 largest stock markets—the ASX has the world's most expensive growth stocks.

Chart 1: 12 Month Forward Price/Earnings of Stocks Forecast to Grow Earnings per Share by More Than 20% over FY1 to FY3



Source: Goldman Sachs Global Investment Research, Bloomberg

While interesting for Australian investors, you might not think that has much to do with the International Fund. But the comparison is useful. And there is something on the far right of that chart that is even more interesting. It suggests that the median Hong Kong growth stock trades at just 17 times earnings.

We love companies that are likely to grow. We just don't like paying up for them. Thanks to Trump's trade wars, widespread pessimism about the Chinese economy and a headlong rush for perceived safe havens, on the Hong Kong stock exchange you can have your cake and eat it too.

There is no better example than a recent addition to the International Fund, **Ausnutria Dairy Corporation** (HKSE:1717).

China's insatiable demand for quality nutritional products has seen Australasian company **A2 Milk** (ASX:A2M) hitch its wagon to the world's most populous nation. With around three quarters of its revenues sourced from China, directly and indirectly via the daigou channel, the company saw its share price rise almost eightfold in the last three years, backed by strong revenue growth and earnings acceleration.

Back in 2014, A2 was a sleepy New Zealand company generating roughly NZ$100m of revenue a year and not making any profit. This year it is expected to make NZ$285m profit on almost NZ$1bn of revenue. It has been an amazing success story, largely thanks to growth in China.

The only problem is that you are being asked to pay NZ$10.8bn for the privilege of owning it (that's A2's market capitalisation at the time of writing).

Up in Hong Kong, you can buy a business with prospects at least as good for roughly half the price.

AUSNUTRIA MILKS THE GOAT IN CHINA

Ausnutria sources, produces and packages infant milk formula and other nutritional products in the Netherlands and Australia and sells it into the Chinese market.

Despite being listed in Hong Kong, the majority of its production comes from Holland, as does its CEO Bartle van der Meer. Like A2, being foreign sourced is an advantage in the Chinese market where consumers are wary of locally sourced product. Like A2, Ausnutria occupies a fast-growing niche in the premium Chinese infant milk formula market. While half its sales are traditional cow-milk powder, Ausnutria has a dominant position in the rapidly growing goat's milk segment. Again like A2, the benefits of goat's milk over cow's milk can be debated (while A2 claims its milk is easier to digest, there doesn't seem to be much scientific evidence supporting its claims). The fact is consumers lap it up.

From just 2% market share in 2012, goat's milk formula was 6% of the Chinese market in 2018 and should keep growing. With one third of the goat's milk market by volume and 60% of the premium product, Ausnutria is likely to keep taking market share.

The barriers to entry are increasing. In recent years the Chinese government has cracked down on misleading marketing in

"FOR ALL OF THAT, AUSNUTRIA TRADES AT A MULTIPLE ALMOST A THIRD LESS THAN A2. IT'S AN ATTRACTIVE PROPOSITION IN ITS OWN RIGHT."

the sector and has introduced a licencing regime that should strongly favour the incumbents. More recently, authorities have also been attempting to restore the fortunes of local Chinese producers of infant milk.

State owned investment fund Citic Agri Fund owns 24% of Ausnutria which has its own local distribution force. We're not sure consumers will buy the made in China argument in any case, but Ausnutria is better placed than its 100% foreign competitors.

Owning 8% of the company's outstanding shares, van der Meer has more than $300m invested alongside us and is the founder of the Dutch business that today makes up the majority of Ausnutria. He is 73 years old, so succession is going to be important, but for now the company is in a safe pair of hands.

There are all the usual risks around doing business in China, but we're confident this business will grow at a healthy clip for some time yet. We have it pencilled in for 25% revenue growth this year. Thanks to operating leverage, that should mean profit growth of almost 50%. Based on reported first quarter growth rates of 29% and 89% for those two metrics respectively, we are hopefully being conservative.

All of that sounds exciting but, of course, it comes down to price. And this is where Ausnutria looks substantially different to A2. The two companies generate roughly the same revenue as each other. We expect Ausnutria to grow at least as quickly. We like the local ownership. And, while its profit margins are currently lower, we think that is part of the upside as Ausnutria growth translates to higher margins in future.

Table 3: Ausnutria Table

	Ausnutria Dairy	The a2 Milk Company
Market capitalisation (AUD million)	4,557	10,366
Price-earnings ratio	29.1x	40.0x
Enterprise value to EBIT ratio	18.5x	26.3x
Price to book ratio	5.5x	13.8x
Dividend yield	1.2%	na
Return on equity	25%	49%
EBIT margin	13.6%	32.7%
Net profit margin	11.4%	22.7%

Source: Forager Funds, S&P Capital IQ

For all of that, Ausnutria trades at a multiple almost a third less than A2. It's an attractive proposition in its own right. Relative to the world's most expensive growth stocks, it looks like a steal.

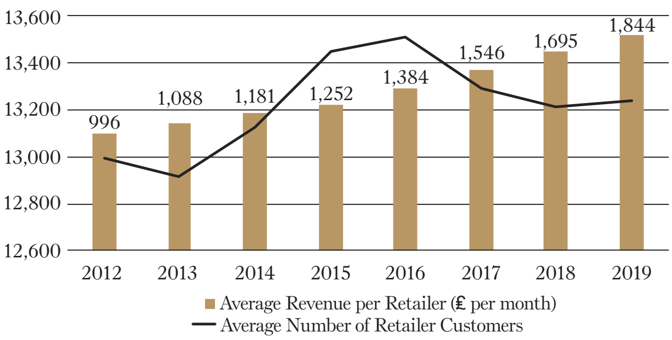
AUTOTRADER: PREMIUM BUSINESS, PREMIUM PRICE

The Fund bought shares in dominant UK used-car portal **Auto Trader** (LSE:AUTO) in early 2018 and highlighted its charms in the March 2018 Quarterly Report. Everything has subsequently gone to plan. Auto Trader remains a non-discretionary investment for car dealers looking to move used car stock and maximise the profit of their own business. Sales for the year ended 31 March 2019 rose 8% to £355m through a mix of new products and price increases. Underlying earnings per share grew faster than 10%, thanks to operating leverage and share buybacks reducing the outstanding share count. The group returned a whopping £151m via buybacks and dividends over the year.

Auto Trader will grow nicely for years yet, and not via unjustified price gouging. Car purchases in the distant past tended to involve visiting a half-dozen dealer forecourts kicking tyres. Print advertisements merely pointed out which dealers to visit. Online classifieds progressively changed that game. Today's buyer has done a lot more research from their own couch. They'll now usually visit only one or two dealers before buying. And they'll typically know the car they want and the price they'll pay.

Chart 2 shows the financial impact of that process for Auto Trader over the past 8 years. About 13,000 dealer forecourts pay to list some or all of their inventory on Auto Trader, a figure barely changed from 2012. But those customers spent, on average, almost twice as much per month in 2019 compared with 2012. Part of this came from the dealer listing more of their stock on the site, part through the adoption of new products offered by Auto Trader, and part through price increases.

Chart 2: Auto Trader Revenue per Retailer



Source: Company filings

“AS THE LEADS IT GENERATES FOR DEALERS GO FROM BEING INQUISITIVE TYRE KICKERS TO QUALIFIED, COMMITTED PURCHASERS, AUTO TRADER WILL RIGHTFULLY TAKE MORE OF THE PIE.”

Further changes are coming that will shift more of the car buying process from the dealer forecourt to your lounge room. Soft approval for financing, confirmed prices for trade ins and the ability to place a refundable deposit to reserve the car are a few examples that will soon be doable from home via Auto Trader. Soon after, it’s likely, many of us will simply order a car online and have it delivered to our door.

The company is getting ‘closer to the transaction’ with each step. As the leads it generates for dealers go from being inquisitive tyre kickers to qualified, committed purchasers, Auto Trader will rightfully take more of the pie. Dealers will be able to afford it by cutting down on sales and financing people, superfluous inventory and real estate.

Auto Trader is a great business. It’s also increasingly being priced as one. The stock is up 53% on the Fund’s average purchase price and trades at 25 times forecast earnings per share for the year ended 31 March 2020. We’ve sold more than half the initial position over the past few months and the current weighting sits at 3.7%. Businesses of this calibre deserve a lot of valuation leeway, but that weighting may drop further over the coming months.

BAIDU MAKES AN UGLY EXIT

Not every investment runs so clearly to plan. Including our investment in Chinese search engine company **Baidu** (NASDAQ:BIDU). The Fund first acquired a stake in the last serious Chinese economic wobbles in early 2016. At the time, immense and growing profits from Baidu’s core search business were being masked by management’s push into Transaction Services—apps for restaurant bookings, food delivery, ticket ordering and more. It was a segment that had already been won by other players. Our thesis was that Baidu would soon recognise the misallocation of resources and shut down or sell the money pit. That played out as hoped for and Baidu’s margins again ballooned, for a while.

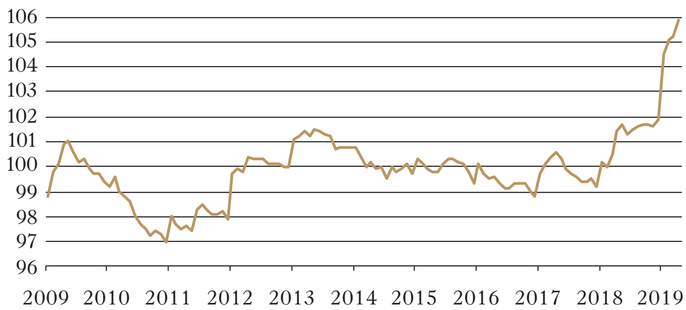
What we mistook was the scale of some of the threats to the core business. Soon after our purchase, a scandal highlighted the atrocious quality of much of the health information available via the search engine (see October 2016 Monthly Report), a multi-year clean up job. Adjacent competitor WeChat, owned by **Tencent** (HK:700), is becoming an ever more important part of the Chinese internet. Baidu’s management are aware of the threat and are once again investing a larger slice of current profit into new areas—artificial intelligence, speech activated systems, driverless auto and more. As a result, margins on the core business have been dropping quarter by quarter, from 35% a year ago to a dismal 6% in Q1 2019. We think that’s the right move for the long term prospects of Baidu. Some of these investments will pay off. But this will be a longer struggle than either the health scandal or the Transaction Services misstep and the range of potential outcomes is wide. We’ve got higher conviction bets elsewhere, and recently sold the stake in Baidu for a 35% loss.

MARKET OUTLOOK IMPROVING FOR CEMENTIR

Cementir (BIT:CEM) has been a strong performer recently, up 24% since December. The outlook and valuation remains attractive. The company has repositioned its portfolio by divesting its Italian assets and acquiring businesses in mature markets such as the United States. Moreover, it is also in the process of moving its corporate headquarters from Rome to Amsterdam.

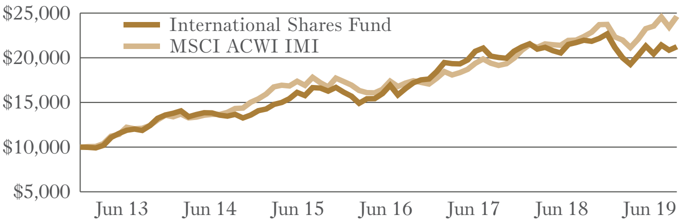
The market outlook is also looking better. Cement consumption in Europe has been growing steadily since its 2014-15 trough, with industry-wide factory utilisation improving too. Pricing, having been relatively flat in Europe for the past six years, has finally been moving up recently in both Western Europe and the United States, Cementir’s core markets. A few industry giants, including **LafargeHolcim** (SWX:LHN) and **Heidelberg** (DB:HEI), are tipping further price rises. The problem child in the portfolio remains the company’s Turkish business, which continues to suffer from margin compression due to rising input costs and a depreciating currency. Nevertheless, the Turkish lira has recovered by 7% versus the US dollar since its May lows, a positive sign.

Chart 3: European Cement Price Increasing After a Multi-Year Stagnation (Indexed Price*)



*2015=100
Source: Bloomberg

Chart 4: Comparison of $10,000 Invested in the Forager International Shares Fund and MSCI ACWI IMI



Source: S&P Capital IQ
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance. Assumes distributions are reinvested.

Chart 5: Portfolio Distribution According to Market Capitalisation

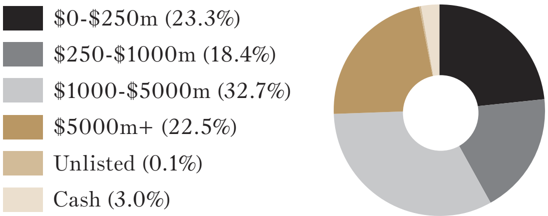


Chart 6: Stock Exposure by Geography

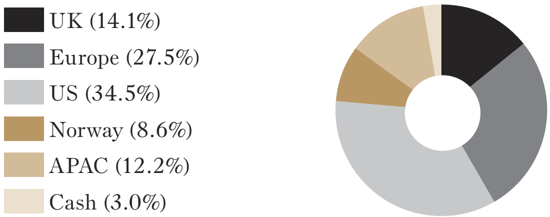


Table 4: Top 5 Investments

Blancco Technology Group Plc	10.3%
Alphabet Inc	5.8%
Flughafen Wien AG	5.8%
Linamar Corp	5.4%
Cementir Holding S.p.A.	5.3%
Cash	3.0%

PORTFOLIO NEWS

Flughafen Wien (WBAG:FLU) has seen an unusual growth spurt over the past year. Management's outlook is for 8-10% passenger growth this year. It's a conservative call—passenger growth over the first 5 months of 2019 eclipsed 20%, although that rate of growth will tail off as the year progresses.

Low cost carriers like Eurowings and easyJet are an important component of that growth. They require fee reductions from airports in order to open up new routes. That's the chief reason the airport's revenue growth is lagging passenger growth. In the first quarter of 2019, passenger growth of 20% translated to revenue growth of 8%, further depressed by some issues in the baggage and handling operations. Through the magic of operating leverage, though, earnings before interest and tax increased 15% and net profit after tax jumped 18%.

Earnings will grow meaningfully over the next few years. And with most of the group's debt paid off, more of those earnings will be returned to shareholders via dividends. The dividend payout ratio is ratcheting up from 50% to 60% and should go higher over time. We met with management during the quarter to discuss the challenges and opportunities stemming from outsized passenger growth, most immediately the terminal expansion underway that will add substantial retail space. Beyond that looms the construction of a third runway, which is at least a decade away from operation.

It remains one of the most attractive infrastructure investments in the world.

The UK government has been outsourcing critical services to the private sector for decades. The rest of the world is way behind. This presents a large opportunity for engineering services provider **Babcock International** (LSE:BAB). And one that they are well placed to capitalise on. This was one of the more interesting points at the company's Capital Markets Day earlier in the month.

Babcock reiterated their medium term target to continue growing (albeit slowly) while sustaining margins, generating cash flow and paying down debt. Management also mentioned the company's ability to pay more money to shareholders for the second time in as many months. If all of this plays out, we should do well from the stock. Babcock currently represents 4.4% of the Fund's assets.

It has been a controversial month for **Alphabet Inc** (Nasdaq:GOOG). The Justice Department is reportedly looking to launch another antitrust investigation into Google. The company is no stranger to regulatory scrutiny. The department investigated Alphabet, without action, in 2013 and the European Commission fined the company $1.7 billion in March this year for anti-competitive practices. Alphabet appealed the EU fine this month. In addition, a number of independent shareholders voiced their concerns with the company's executives at the annual meeting. Groups of protestors outside the meeting, and other Google offices, shared their sentiment. The share price is down 2.1%, since the start of the month, while other large tech stocks have rallied strongly.

AUSTRALIAN SHARES FUND

FACTS

Inception date	30 October 2009
ASX Code	FOR
Income distribution	Annual, 30 June

UNIT PRICE SUMMARY

Date	30 June 2019
NAV (cum distribution)	$1.30
Market price (cum distribution)	$1.15
Distribution	2.17c
Portfolio value	$147.7m

FASF BUILDS FOR LOW RATE WORLD

Interest rates on deposits, already woefully low, are likely to be at or near zero within a few years. The case for investing in strong businesses with reasonable dividend yields and the ability to withstand an economic downturn remains compelling, despite the rally in ASX stocks this year. Two that we think fit the mould are **Smartgroup** (SIQ) and **SG Fleet** (SGF).

Table 5: Summary of Returns as at 30 June 2019

	Australian Fund (Net of fees)	S&P All Ords. Accum. Index
1 month return	-1.46%	3.43%
3 month return	-7.28%	7.83%
6 month return	-3.13%	19.76%
1 year return	-19.66%	11.04%
3 year return (p.a.)	2.31%	12.62%
5 year return (p.a.)	7.26%	9.02%
Since inception* (p.a.)	9.84%	8.37%

*Inception 30 October 2009
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance. Returns are calculated using NTA, not market price.

Reserve Bank of Australia (RBA) Governor Phillip Lowe told a recent lunch gathering that "it's a strange world" where equity markets rise on the back of interest rate cuts. It may be strange. But it's the world the rest of us have been living in for the past decade.

Globally, whether zero interest rates and quantitative easing have had their desired effect on economic growth and inflation is debatable. There is unequivocal evidence, on the other hand, that the impact on asset prices—equities and property in particular—has been in one direction: up.

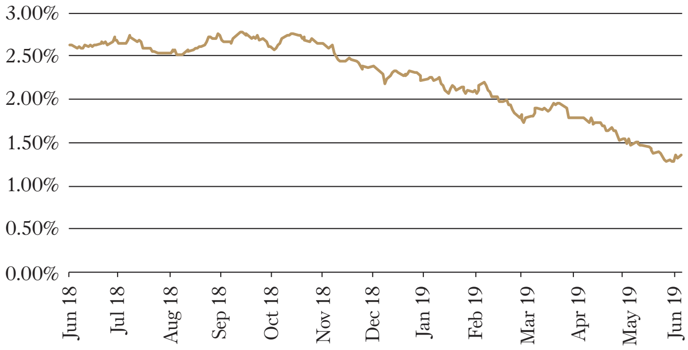
To give Lowe some credit, his comments were directed at those assuming that interest rates fall dramatically and corporate profits don't fall. Surely interest rates will only be cut to near zero if the economy is facing a recession? And that cannot be good for the earnings part of the equation.

Still, by market capitalisation the ASX is dominated by banks, mining companies and large property trusts, all of which pay large distributions or dividends. The yield on 10-year Australian government bonds has fallen from 2.8% to 1.3% in the past 12 months, interest rates on deposits have been slashed and the RBA has suggested several more rate cuts are likely this year.

Is it any surprise that investors have rushed headlong into dividend paying stocks? The only thing perplexing is why the governor is perplexed.

On behalf of Australia's savers, we're hopeful to be wrong on this, but the Forager view is that low rates are here to stay. We are blessed with one of the highest debt to income ratios in the world, mountains of mortgage debt and a dearth of fundamental reform in the past two decades. It is hard to imagine a scenario where rates go back up without cratering the economy.

Chart 7: Australian 10 Year Government Bond Yield



Source: Bloomberg

Interest rates on deposits, already woefully low, are likely to be at or near zero within a few years.

The case for investing in strong businesses with reasonable dividend yields and the ability to withstand an economic downturn remains compelling, despite the rally in ASX stocks this year. Two that we think fit the mould are **Smartgroup** (SIQ) and **SG Fleet** (SGF).

MAKING A SMART CHOICE

Smartgroup administers salary packages for Australian charities and public sector clients. Certain charitable entities are provided an effective subsidy for salary costs through exemptions or concessions under legislation from 1986. This means eligible employees can claim expenses—the cost of a car on a novated lease for example—as a tax deduction.

Complex administration (who can claim what?) is the reason for Smartgroup's existence. In addition to a relatively low fee, paid by the employee, the company earns additional fees from arranging finance, cars, insurance and other services. In fact, that's how Smartgroup earns its profit—commissions, mostly from car novated leases, accounted for 61% of Smartgroup's revenues in 2018.

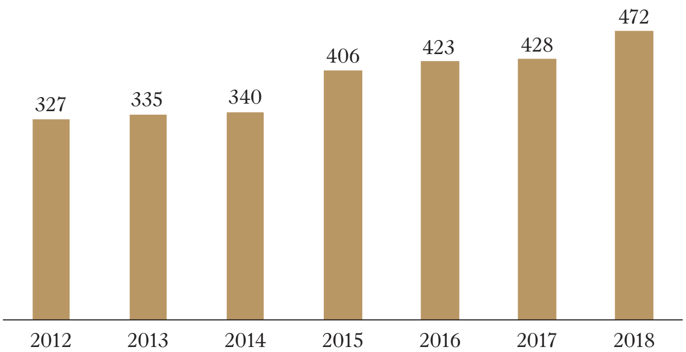
Smartgroup has a stable client base owing to the difficulty of switching administrators. Transitioning is a big project and requires changing systems and processes across HR, IT, finance, compliance, audit and the employees. According to Smartgroup's prospectus, 45% of the company's largest clients have been with the company for more than ten years.

"FOCUS AND SKIN IN THE GAME ARE HALLMARKS OF GREAT CAPITAL ALLOCATORS. IN THE PAST FOUR YEARS, SMARTGROUP TRIPLED THE NUMBER OF SALARY PACKAGES IT MANAGED THROUGH HOOVERING UP SMALLER COMPETITORS—BUILDING SCALE AND EXPANDING PROFIT MARGINS."

Salary packaging uptake and employee numbers will increase naturally and the runway should be decent given rising employment in the health and charity sectors. The number of novated leases will likely follow. Modest growth can occur without retaining any capital.

Margins for earnings before interest, taxes, depreciation and amortisation should also continue to expand with volume growth. Efficiency will improve as unnecessary platforms are consolidated and enhancements continue in online processing and automation. Over the past three years, margins increased from 40% to 46%.

Chart 8: Average Salary Packages (Employee Customers) per Smartgroup FTE



Source: Smartgroup, Forager Analysis

Focus and skin in the game are hallmarks of great capital allocators. In the past four years, Smartgroup tripled the number of salary packages it managed through hoovering up smaller competitors—building scale and expanding profit margins. In 2014 when Smartgroup first debuted on the stock exchange, it had a 20% share of the salary packaging market, compared to McMillan's almost 50%. Today, the two companies are on an even footing. Those acquisitions required capital—the shareholder equity in the business quadrupled over the four years—but the return on equity has been outstanding. In the most recent financial year it was 27%. Earnings per share grew by three and a half times.

Deven Billimoria, Smartgroup's founder and CEO, has $29m of his own wealth tied up in shares. Chairman and former Macquarie Banker Michael Carapiet owns $19m worth of shares too. The largest shareholder, a subsidiary of a Malaysian private investment holding company led by billionaire Ananda Krishnan, keeps a close eye on its 25% holding through its associate Andrew Bolam, a non-executive director on the board.

With the industry now dominated by Smartgroup and McMillan, though, the ability to replicate the acquisitions of the past decade are limited. And the industry has faced existential crises in the past.

BUT OF COURSE, THERE ARE RISKS

Exemptions or concessions for benevolent charitable entities is a form of subsidy. The current salary packaging system has been in place since the introduction of the fringe benefits tax system in 1986. Any significant change to the regime could damage the Smartgroup business. McMillan's share price plummeted when material alterations were proposed by the Rudd government in 2013. While it's a risk that will always hang over the business, the proposed changes proved politically costly in 2013 and, given Labor's disastrous 2019 federal election result, the risk of changes any time soon is low.

There are also more immediate cyclical concerns. While more resilient than demand for new car purchases, demand for new novated lease vehicles has been weak. More customers are refinancing their leases rather than trading in for a new lease, which means lower profits per vehicle for Smartgroup.

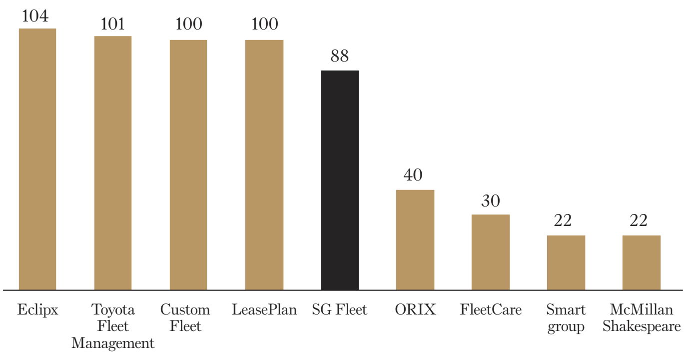
These are all problems we are happy to let the board and management team worry about, though. The company distributed 70% of its profits as fully franked dividends in 2018, equating to a 5.0% yield at the current price. We expect that to prove resilient and rise over time, either through sensible investment of the retained 30% of profits or an increase in the payout ratios if opportunities are hard to come by.

It's best to invest with management teams that think like owners. The easiest way is to invest with those that actually are.

SURPRISING QUALITY AT AN ATTRACTIVE PRICE

The investment proposition at fleet management company **SG Fleet** (SGF) is not dissimilar. SG Fleet manages fleets of vehicles on behalf of government and corporate clients. For a large client that can mean thousands of cars. Fleet management systems need to integrate with procurement, finance and compliance. Drivers need to be in the loop too.

Chart 9: Fleet Management Landscape ANZ (vehicles, thousands)



Source: McMillan Shakespeare, November 2018

"IT'S BEST TO INVEST WITH MANAGEMENT TEAMS THAT THINKS LIKE OWNERS. THE EASIEST WAY IS TO INVEST WITH THOSE THAT ACTUALLY ARE."

Five main players account for about two thirds of the industry. There doesn't seem to be dramatic differences between the product offerings and competition for new clients is fierce.

Once again, though, large industry participants earn very healthy returns on shareholders' capital. There are efficiency benefits to size. And, once a customer has chosen their fleet management provider and integrated the service into their operations, moving to a competitor can be costly, time consuming and risky.

This means for a new competitor, simply replicating SG Fleet's assets is not nearly enough to assure a return on investment. There has been no new competition of scale in the past four decades. All of the five largest fleet managers have been around since the 1980s.

The average customer life for SG Fleet's largest clients was 11 years according to the company's 2014 prospectus.

ATTRACTIVELY PRICED AND WELL RUN

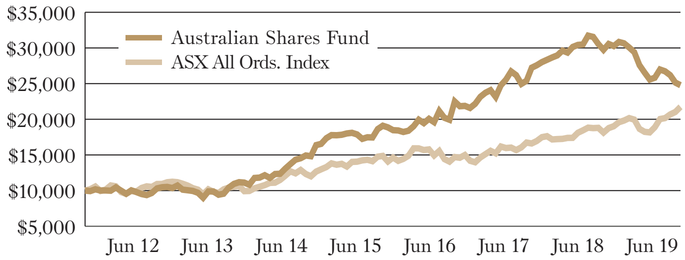
A recession in Australia wouldn't be helpful. Corporate clients might reduce demand for new vehicles but even if growth slows, the total fleet size should be stable given the mostly non-cyclical customer base. And about one third of SG Fleet's business is with retail leasing clients, where demand is already diminished. The balance sheet is strong and the long-term structural tailwinds to fleet outsourcing are helpful. There is also the possibility of further sensible acquisitions.

South African fleet management business Super Group owns 59% of the company and the capital allocation track record under its watch has been sound. Robbie Blau, the CEO, personally owns $20m worth of shares.

The business is attractively priced at an 11 times price-to-earnings ratio and pays a 6% fully-franked dividend yield. At the very least, we think that is sustainable.

Both SG Fleet and Smartgroup have been added to the Forager Australian Shares Fund portfolio in recent months. We're not expecting anything spectacular. But healthy yields, robust businesses and strong shareholder alignment are particularly attractive in a world of zero interest rates.

Chart 10: Comparison of $10,000 Invested in the Forager Australian Shares Fund and ASX All Ords. Index



Source: S&P Capital IQ
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance. Values are at NAV, not market price. Assumes distributions are reinvested.

Chart 11: Portfolio Distribution According to Market Capitalisation

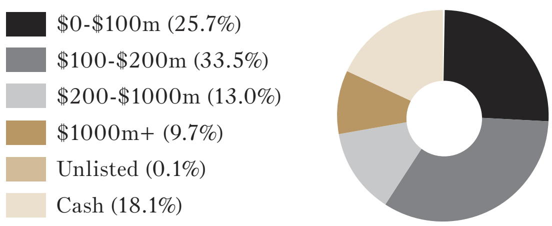


Table 6: Top 5 Investments

Enero Group Limited	11.7%
iSelect Limited	7.9%
Macmahon Holdings Limited	6.7%
MMA Offshore Limited	6.0%
Carsales.com Limited	5.1%
Cash	18.1%

PORTFOLIO NEWS

Mining contractor **Macmahon** (MAH) has problems with Telfer, the company's worst performing contract. With mine owner **Newcrest** (NCM) changing mining requirements, Macmahon had a choice: continue to perform the work and lose money, or fight for higher pay. Macmahon chose the latter and is now in a formal negotiation process, which is due to complete in early August. The result will either be a hit to future profits of up to $35m or a more sustainable, perhaps even profitable, contract.

Other contracts, including the Batu Hijau mine in Indonesia, are performing well and the company expects profit growth next year with just the current workload. A further $5bn of new revenue opportunities are still to be decided. To bolster its underground mining credentials Macmahon agreed to acquire GBF, a specialist underground contractor, for $48m upfront and a performance-dependent payment of $54m.

The news didn't stop there. Two independent directors, including the Chairman Jim Walker, left the business in late June. The abrupt nature of their departure and lack of immediate replacements suggest serious disquiet in the boardroom. We are assured by both sides of the argument that there is no one decision causing the fissure, but new Chair Eva Skira will need to find strong replacements to reassure investors.

Meanwhile, print and technology services provider **CSG** (CSV) exceeded expectations by confirming it will deliver the bottom end of its guided profit range this year. CSG had failed to deliver to guidance for years.

The new executive chairman, Mark Bayliss, has made some big changes since being appointed a year ago. Costs have been reduced, inventory slashed, and culture reformed. Key financial, marketing and technology roles have been filled with new managers. With the new lineup CSG is expecting to grow earnings next year.

Fund administrator **Mainstream Group** (MAI) reported a record level of funds under administration. At the end of March, the company was administering $163bn for fund managers around the world. This was up 11% since December and an impressive 23% from the prior year, benefiting from higher equity prices. But Mainstream also saw inflows into current clients' accounts, beat out competitors to $5.1bn worth of client funds and helped 38 new funds establish operations. The company has also renewed an agreement with its largest client, **Magellan Financial** (MFG), for another five years.

Consumer leasing and equipment finance company **Thorn Group** (TGA) released its results for the 2019 financial year. Cash net loss was $7.9m, down from last year's profit of $18.5m. The result was muddied by a gain from a sold business, write-offs of equipment and software, and a $11.5m default in the business equipment division.

Its Radio Rentals business grew installations by 1%, but after a few slow years the lease book shrunk by 11%. Bad debts rose to 18% from 13% as Thorn struggled to collect payments from clients after a change in collection methods. We continue to engage with the company to realise the value in the business.

Skydiving and adventure tourism business **Experience Co** (EXP) reduced expectations for current year's profits. Cairns continues to suffer from low tourist arrivals, affecting the company's suite of skydiving, white-water rafting and Great Barrier Reef trips. The late season arrival of Cyclone Ann also halted operations. Poor performance looks likely to continue into the next financial year in the North.

But Cairns tourist arrivals have grown 2.5% a year over the last decade. While visitors are down 4% over the last six months, in May arrivals fell just 2%. And it looks like the company is not losing market share to other Cairns tourism operators. A return of local and international travellers to the city will benefit Experience Co's activities.

Outside of Far North Queensland it was better news—the number of skydivers is expected to increase by 5% this year. With the company's dominant market share it should benefit from continuing skydiving growth for many years.

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Forage
verb, for·aged, for·ag·ing.
to search about; seek; rummage; hunt (for what one wants).