FORAGER

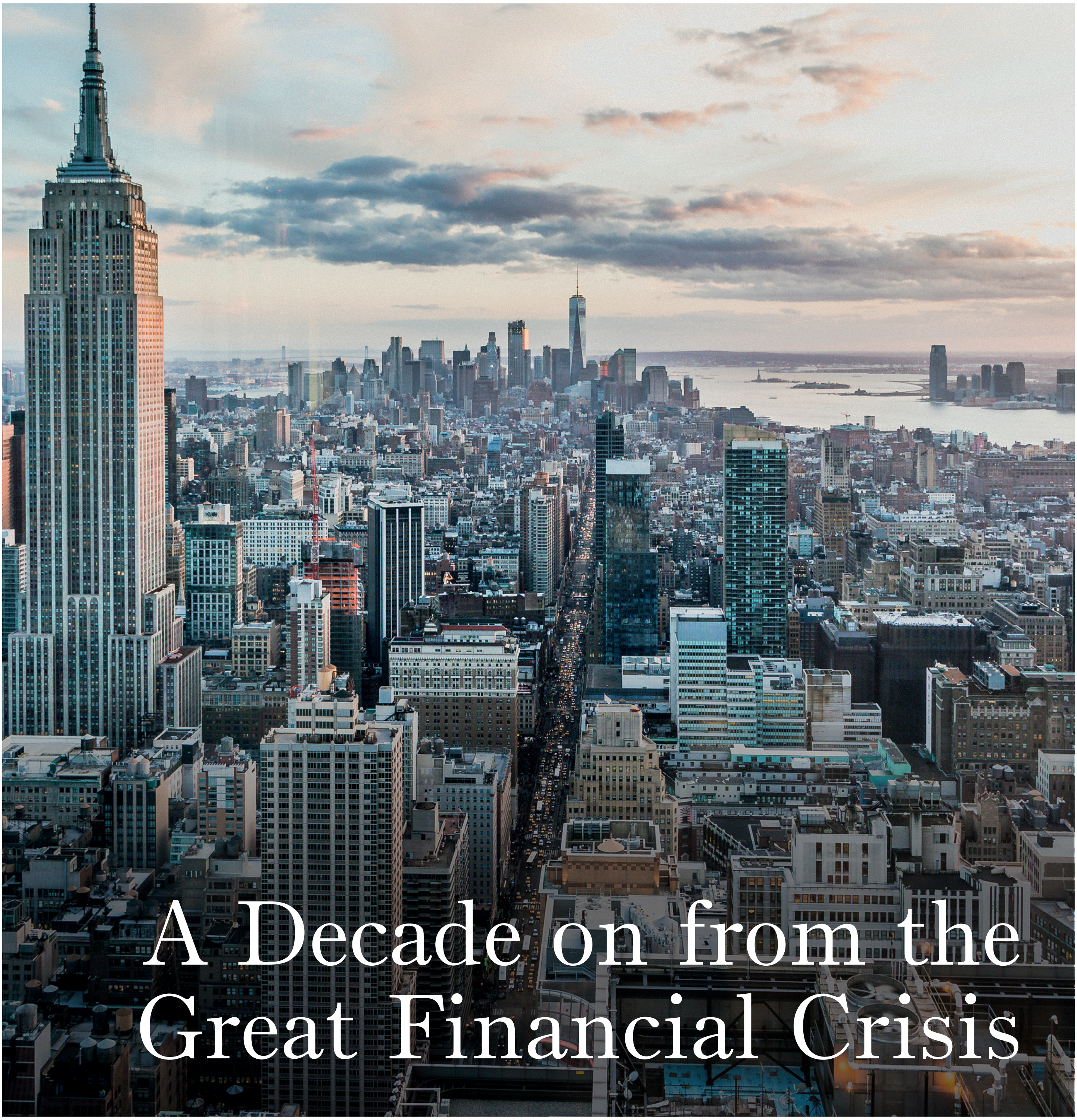
SEPTEMBER 2018 QUARTERLY REPORT

BLANCCO'S SIMPLE STRATEGY
The share price is up, but Blancco's new CEO has plenty of opportunity ahead

GULF MARINE BUILDS ITS BACKLOG
Looming oil shortages are good news for GMS as key clients increase spending

NO FREEDOM FROM THE ROYAL COMMISSION
Lessons from a losing investment in a direct funeral insurance business

PREPARING FOR THE PROPERTY CRASH
We are not predicting disaster or salvation. Instead we are trying to be prepared



A Decade on from the Great Financial Crisis

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LOOKING BACK ON THE FINANCIAL CRISIS

It has been a decade since the collapse of Lehman Brothers spruned the greatest financial collapse since the Great Depression. Much has been learned and much, it seems, hasn't.

It was the worst six months of my working career. Markets had been in a tizz for a while prior to September 2008. US residential property prices had started to fall in March 2007. Rams Home Loans listed on the ASX in June of that year and was in disarray a few weeks later. US funding markets from whence it derived its business had collapsed.

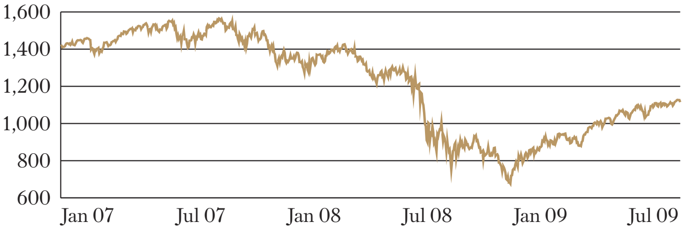
For most of the next year or so, markets wobbled and dipped and waxed and waned. The S&P 500, a broad index of US stocks, had suffered multi-week losses of more than 10% on a number of occasions. A few hedge funds run by Bear Stearns, focused on credit securities, collapsed. But in August of 2008 both the S&P 500 and the All Ordinaries Accumulation Index were within 20% of their all time highs. Many of us were seeing opportunities in the dips and, like we had been for most of the previous 20 years, had been getting well rewarded for buying in the early signs of panic.

Then Lehman Brothers collapsed on 15 September 2008 and my world was turned upside down. Older investors talk of the 1987 crash as their defining moment. For me, this was the first time I had seen financial markets become completely dysfunctional.

Allco Finance and Babcock and Brown, two multi-billion dollar Australian financial institutions, collapsed in November 2008 and March 2009 respectively. Share market moves of more than 5% were happening almost every day. Financial institutions stopped trusting each other and funding became inaccessible to all but a small handful of the safest businesses. Another Great Depression seemed probable.

From that August 2008 level, the S&P 500 fell a further 48%, taking the total losses to 57% from the all-time high. Our own market suffered similarly. They both bottomed in early March 2009. Coincidentally or not, Warren Buffett gave an unusually long interview on CNBC and took questions from readers.

Chart 1: S&P 500



Source: S&P Capital IQ

Losing my own money was the least of my concerns during those torid months. In fact, my own personal portfolio had hit its nadir well before the crisis fully took hold. One significant investment, Timbercorp, collapsed in 2007. Another, my most significant holding RHG, had already turned the corner. Having listed at $2.50 per share, RAMS Home Loans traded at less than 5c on 30 June 2008. In August that year, though, it sold its brand to Westpac, changed the name to RHG and was throwing off plenty of cash. By the time stock markets were melting down, RHG was headed the other way. It closed north of 20c per share on the day markets hit their lows.

Far more harrowing was the performance of the business I was responsible for. Back in 2004, a small group of us had bought the stockmarket research company Intelligent Investor. The first few years were good and we were able to repay most of the money we had used to acquire the company from its founders, John Addis and Robert Carey. When the stockmarket crisis hit, however, we had a cost base that was far too high and a significant liability that we hadn't given much thought to.

The balance sheet on the day we bought Intelligent Investor has something like $3m of "subscriptions received in advance" on the balance sheet. This liability represented cash that had been paid upfront for subscriptions of one, two and three years. While the business only had $50k of cash in the bank, it generated good cashflow and, as long as you replaced every old liability with a new one, what was there to worry about?

When our subscriber numbers halved between 2007 and 2010, not only did we have a cost base far too high for our subscriber numbers, we were still reporting revenue from—and, most importantly, paying tax on—subscribers who had paid us years ago and were never going to pay again.

Telling colleagues—close friends with families and mortgages—that they don't have a job any more was the worst experience of my life. We managed to pull through. The Intelligent Investor business survived and somewhere in the carnage I managed to start a funds management business.

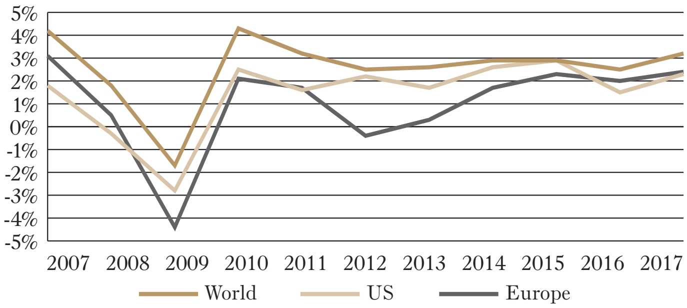
It was an experience that shaped and scarred a generation. The effects are still being felt today. I have no doubt that some effects are still to be felt.

A DECADE OF SLOW GROWTH, RISING ASSET PRICES AND DEBT

In 2009 Carmen Reinhart and Kenneth Rogoff published *"This Time Is Different: Eight Centuries of Financial Folly"*. It has since been the subject of seemingly valid criticisms including, apparently, fundamental spreadsheet errors. But the key message I took from it—that recoveries from financial crises are much longer and slower than those from normal economic recessions—has proven spot on.

Only in the past 12 months have there been signs of global GDP growth reaching historical averages, let alone the above average rates normally associated with an economic recovery.

Chart 2: World GDP Growth



Source: Bloomberg Intelligence

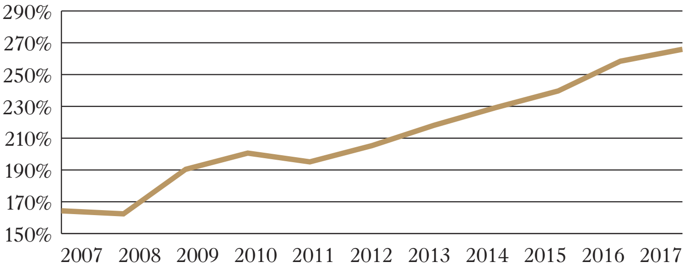
The sluggish, inflation-less nature of the recovery has had important implications.

Monetary policy has remained extraordinarily accommodative for far longer than anyone anticipated a decade ago. I'm not sure whether that has saved the world or not, but it has unequivocally driven up asset prices across the board as investors reached for yield.

The lack of growth and high unemployment has translated to a lack of wage growth for the average worker in developed countries. Watching rising asset prices benefit the rich while employees experienced declining real wages has created a febrile environment for political upheaval. The Donald Trump presidency and Brexit are both long term consequences of the events of 2008-9.

Debt levels have continued to rise, particularly in countries like China and Australia that were less affected by the crisis. Sustained low interest rates have allowed companies, consumers and governments to continue piling on the leverage without many consequences, yet.

Chart 3: China—Debt to GDP



Source: Bloomberg Intelligence

Despite a long bull market, investors enthusiasm for stocks has been reluctant. From the early days of the recovery, many have been of the strong opinion that a repeat of the financial crisis was around every corner. The problems weren't fixed, the argument went, just deferred.

There is definitely an element of truth to the argument, as the debt chart above shows. But it has been a very expensive standpoint. Cash in the bank has earned close to zero, while real asset classes like property and equities have doubled and tripled while investors waited on the sidelines.

And vast fortunes have been made on a scale not seen since the start of the previous century. In July 2018, Facebook founder Mark Zuckerberg passed Warren Buffett to become the third richest person in the world. He was 24 years old when Lehman Brothers collapsed.

Mike Cannon-Brookes and Scott Farquhar founded Australian tech company Atlassian in 2002, apparently funding the business with a credit card. Today they are in the top 12 richest Australians.

Not since the days of John D Rockefeller (oil) and Andrew Carnegie (steel) have such vast fortunes been created in such short periods of time. The main reason is that markets have become far more global. Winner takes all markets are nothing new, but they were historically geographically constrained. Each city had one or two dominant newspapers, for example. Today's winners, like Facebook and Google, are global and require minimal amounts of capital. Investors have frequently underestimated how powerful that can be, even once the dominant player has been established.

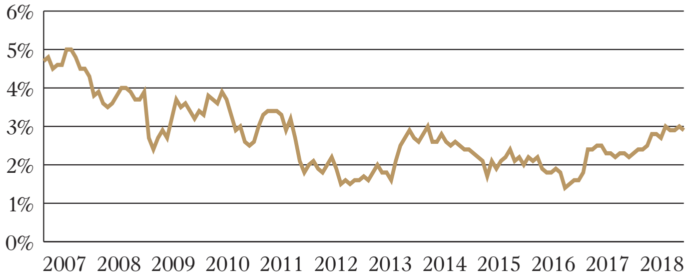
HAVE WE LEARNED ANYTHING?

Buying shares in March of 2009 might seem simple in hindsight. At the time, with another great depression hanging over our heads, it wasn't easy. Just working out which businesses were going to survive was hard enough.

Today's challenges are different, but the correct decision is no easier.

Signs of inflation are becoming more prominent. Wage growth in the United States has finally edged up. Interest rates have started to rise in the US, including more recently on longer term bonds which are most relevant for other long-term asset classes.

Chart 4: US 10 Year Treasury Yield



Source: Bloomberg Intelligence

At a recent conference in Germany (see page 6), the one consistent theme was cost pressures, supply shortages and wage inflation. The days of sluggish growth may well be coming to an end, but that is unlikely to be good news for asset prices.

The only way prices for Australian property, US stocks or corporate bonds make any sense is if interest rates stay low for a very long period of time. We have had a decade of asset prices rising without much economic growth. We could well be in for a decade of better growth but poor returns for investors.

But that's not a reason to pack up and go home. Equities are still priced to deliver much better returns than bonds, cash or residential property (in Australia at least). Being substantially out of the market can be very costly. And there are plenty of individual businesses that are going to deliver wonderful returns over the coming decade.

The team at Livewire gifted me a copy of *Factfulness* by Hans Rosling after my presentation at their 2018 live event. It's a wonderful summary of the progress humanity has made over the past 50 years, and even the past 10. The rich world doesn't notice it because we are already rich but life has improved dramatically for a huge swathe of the world's population.

As investors we need to be sceptical and wary. But we also need to keep progress in mind. The only way to grow your real wealth is to stay invested in real assets. There may well be another financial crisis around the corner. There will also be another Atlassian.

Kind regards,

STEVEN JOHNSON
Chief Investment Officer

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	28 September 2018
Buy price	$1.7009
Redemption price	$1.6942
Mid price	$1.6975
Portfolio value	$188.7m

BEAUTIES AND BEASTS IN EUROPE

A recent trip to Europe was mostly focused on existing investments. With one significant exception, the Fund's key holdings are progressing well.

Table 1: Summary of Returns as at 28 September 2018

	FISF (Net of fees)	MSCI ACWI IMI
1 month return	2.22%	0.11%
3 month return	3.19%	6.08%
6 month return	10.34%	10.92%
1 year return	9.27%	18.89%
3 year return (p.a.)	11.69%	12.35%
5 year return (p.a.)	13.82%	14.41%
Since inception* (p.a.)	15.61%	16.57%

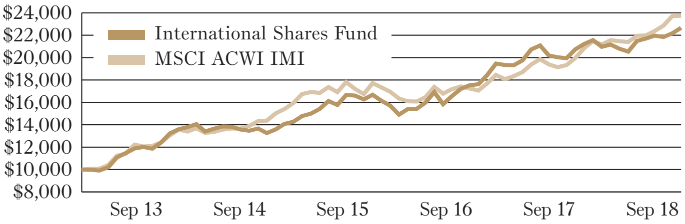
*Inception 8 February 2013
The value of your investments can rise or fall. Past performance is not necessarily indicative of future performance.

In September we visited most of the Fund's European investments and were generally pleased with the progress. Our first stop was Munich for the annual Baader Bank conference for German, Swiss and Austrian companies. Before you question the coincidental timing, we (unfortunately) did not set foot in an Oktoberfest tent. But it was a useful week nonetheless.

In addition to meetings with portfolio investments **Rosenbauer** (WBAG:ROS) and **Flughafen Wien** (WBAG:FLU), we saw more than 30 companies present and added a few new stocks to the wish list.

Fire truck manufacturer Rosenbauer International has been a disappointing investment over the past four years. Sales to the Middle East were flying back then. We'd built our thesis on a dramatic contraction in that market. But reality was even worse thanks to the massive drop in oil prices that followed. Middle Eastern markets are now firmly recovering.

Chart 5: 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.

Developments in Central European markets were equally painful. Over the past few years, sales in Germany have been very strong but segment profitability all but evaporated as Rosenbauer and its competitors all bid aggressively for new tenders. Its key competitors are mostly losing money.

We took the message from new CFO Sebastian Wolf, one of a slew of new senior appointments, that Rosenbauer is doing its bit to bring normalcy back to pricing in Germany, even if that means losing new contracts.

The company currently has a record order book and a tailwind at its back. It should be able to fix its profitability issues over the next year or two. If it can't in this environment, it never will.

Progress at Flughafen Wien has been more pleasing. It's done a stellar job of attracting new airlines and routes to replace the loss of its second biggest customer, Air Berlin, to bankruptcy in 2017. Its biggest customer, Austrian Airlines/Lufthansa, has provided some of that growth, as have long haul flights from new Asian destinations. But the biggest new share comes from low cost airlines like Easyjet and Eurowings.

Passenger growth across the group over the first eight months of 2018 is up 8.4% on the prior year, with growth rates over the important June-August period even higher. Attracting new airlines and new routes mean providing incentives, so revenue hasn't grown as fast as passengers this year, up 4.5% for the first half. But we expect revenue growth to follow passenger growth over time. Through the power of operating leverage, profitability should grow faster than revenue.

From Munich Germany it was a schnell departure for London in order to catch **Blancco Technology Group**'s (AIM:BLTG) new CEO Matt Jones on his way out of the country.

BLANCCO TECHNOLOGY PLANS SENSIBLE AND FOCUSED GROWTH

Thanks to some rapid recent share price appreciation, Blancco has become the largest holding in the portfolio and Jones is going to have a big say in how it performs from here. But let's start this story from the beginning, it hasn't been told in a quarterly report before.

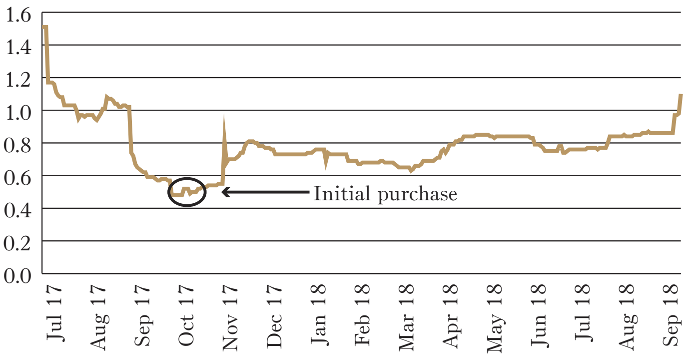
This time last year, Blancco's last full-time CEO had just been punted, with good cause. The 2016 results were in need of restatement because the company had booked revenue on a large contract that never materialised. The 2017 accounts were missing and overdue. The stock price had fallen 80% in a matter of months.

We lent into the wind and bought. On a few days in late 2017 Forager was the only buyer of stock. And we weren't letting the

> "EARLY INDICATIONS GIVE US HOPE THAT JONES IS THE RIGHT MAN FOR THE JOB. FOR CONFIRMATION WE CAN ONLY WAIT."

sellers set the price. Those purchases were made at a price that valued the company at a little above one times revenue. This is a business that can and will earn quite high margins, and our thesis is that the business is worth at least three times revenue.

Chart 6: Blancco Technology Group—Share Price (£)



Source: S&P Capital IQ

What we saw then, and are more confident of than ever today, is that Blancco has a genuine business and an outstanding opportunity ahead of it.

The company's roots are in Finland, where in the late 1990s Kim Väisänen and Janne Tervo developed software to permanently delete the contents of a hard drive at the end of a computer's life. Data erasure remains Blancco's most important business today. Specialised IT Asset Disposal firms (ITADs) and large corporate clients deal with mountains of used hardware each week. If data security means anything to them, they'll want to clear all those hard drives before recycling or re-selling their old hardware.

That can be done one of three ways: by physically destroying the hard drive; by 'scrubbing' or overwriting the device (often multiple times); or by using software to methodically clear the drive in a process that is irreversible by hackers. Some such software is available online for free. But if you want a reliable audit trail and a guarantee it's been properly cleared, you'll use a piece of paid erasure software. Overwhelmingly Blancco is the global leader in paid erasure. Its customers buy licences typically linked to usage, and repeat business is very high.

The other important part of the business is Diagnostics, a business which is focused on servicing mobile phones. Blancco diagnostics units are sitting in thousands of stores of one of the big US telcos. Each week, they perform around 100,000 diagnostics tests, helping customers identify and solve problems with their mobile phones.

Typically, customers walk away with their existing phone functioning properly again. When the problem can't be solved, the unit helps shop assistants transfer apps and data from the customer's old phone over to their newly purchased phone, and clear the data on their old phone with Blancco erasure software so it can be sold into the second hand market or sent for recycling.

Blancco's Diagnostics business is one of a handful of players globally, with a long runway and consolidation opportunities ahead.

New CEO Jones joined the business back in March and has just released his first set of results and an updated strategy for the company. The results confirmed that Blancco's problems were temporary. And the strategy, thankfully, is simple: focus on what the company already does well.

It all looks wonderful in the CEO's strategy presentation. The business is centrally placed in an industry that is going to grow for many decades to come. But business success depends more on execution than ideas. The management team will have some big calls to make over the next few years and for us to make lots of money they need to be right. Early indications give us hope that Jones is the right man for the job. For confirmation we can only wait.

JUST GROUP NEEDS TO JUSTIFY ITS PLACE IN THE WORLD

Later that day we met with a company whose share price performance has been having an offsetting impact on the Fund's returns.

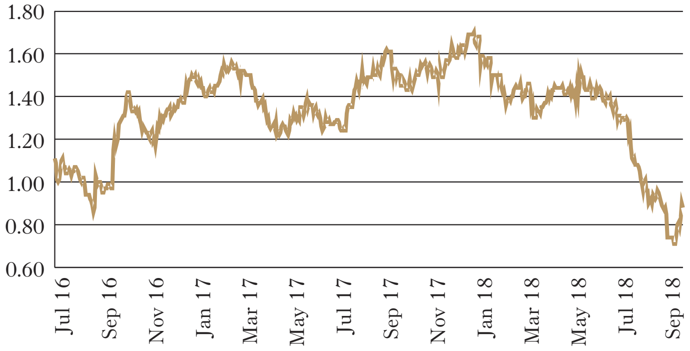
Since Forager first purchased shares in **Just Group** (LSE:JUST), in August 2016, the annuity provider has made excellent progress. It generated an operating profit of £124m in the six months to 30 June this year, more than double the £48m it generated in the same period of 2016.

Demand for its products is strong. Sales of Just's annuities increased 64% in the first half of this year. More importantly, the margin it earns on those sales increased to 10.2%, up dramatically on the 6% margins it earned in 2016. Just Group and its competitors are all suggesting a robust pipeline of opportunity for more than a decade to come. Unfortunately, the share price is down, not up, on the back of all of this good news.

The UK insurance regulator, the Prudential Regulatory Authority (PRA), is unhappy with the way Just Group is funding its business. Annuity providers collect cash from investors on day one and in return provide a fixed regular payment for as long as the investor stays alive. The returns they are able to offer depend on how they invest the money and what sort of return they are able to achieve.

“THE PRA WANTS THE INDUSTRY TO HOLD MORE CAPITAL AGAINST ERMS IN CASE SOMETHING GOES WRONG, AND JUST HAS BEEN THE MOST PROLIFIC USER OF THE ASSET CLASS.”

Chart 7: Just Group—Share Price (£)



Source: S&P Capital IQ

In the UK, Equity Release Mortgages (ERMs) have been a popular asset class for annuity providers seeking additional returns. ERMs have also been popular with retirees seeking to access some of the wealth tied up in their houses —the interest on an ERM is added to the outstanding balance so the borrower never needs to repay interest or principal.

They are less popular with the PRA, which is of the opinion that the annuity providers are taking on more risk than they realise (if the borrower lives a long time and house prices fall, it is possible the loan grows to more than the value of the house and the annuity company loses money).

The PRA wants the industry to hold more capital against these ERMs in case something goes wrong, and Just has been the most prolific user of the asset class. Under a worst case scenario, Just might need to increase its shareholder equity by a quarter. Investors, seeing a forced capital raising on the horizon, have sold the shares aggressively.

From an economic perspective, we share some of the PRA's concerns. Loan to value ratios on ERMs had been creeping up, rates on the loans were edging down, and the company's assumptions about future house price growth were aggressive. Since the potential changes were announced, the whole industry has changed its pricing and terms in favour of shareholders. We may well look back in a decade and thank the regulator for its foresight.

In the short term, though, that won't help Just. The PRA was taking industry feedback until 30 September and will announce its final policy by the end of year. There is a wide range of potential outcomes but Just is likely to need more capital under all of them.

The shares have recently traded at levels as low as half its tangible book value. That is an extraordinarily low price for a key participant in an attractive, growing sector of the UK's mature insurance industry.

It should be attractive for an acquirer. It should be attractive for potential shareholders. But until the capital issue is behind it, the shares will remain at the mercy of the market.

DOLPHIN CAPITAL LIQUIDATION PROGRESSING

In addition to a handful of other meetings in London, we met with several board members of **Dolphin Capital Investors** (AIM:DCI) to discuss progress of the company's measured liquidation of its resort lands in Greece, Cyprus and Croatia. We then travelled to Greece to eyeball some of its larger assets.

The August sale of the only operating asset, the loss-making Amanzoe Resort, simplifies things. It garnered a full price in our view. We think the next larger asset sale will start seeing capital returned to long-suffering shareholders. But progress with the Kilada golf resort will be the most important factor to maximising total returns—this development now has necessary approvals, a partial outside equity backer and is on the verge of getting bank financing for the first stage. Our preference is for the company to find a buyer for this asset soon after those hurdles have been cleared, a message we've shared with the board.

The downside is fairly limited from here and we're hopeful of making a decent return on the Fund's investment over the next 2-3 years.

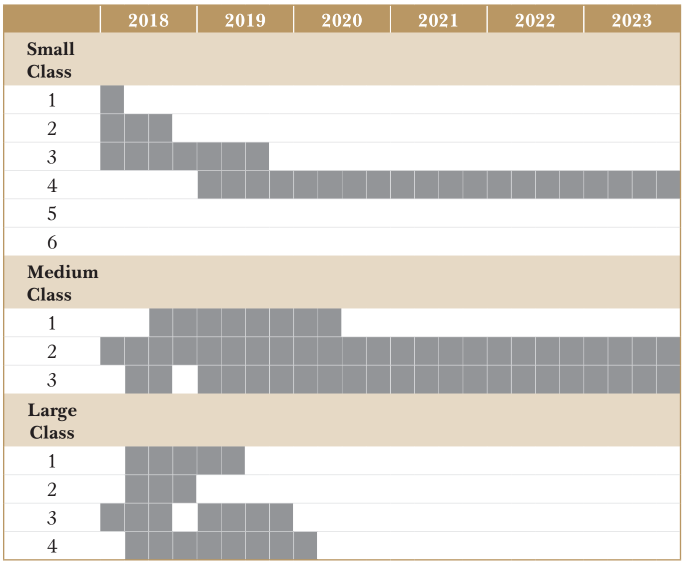
GULF MARINE BUILDS ITS BACKLOG

On the way back to Australia, we stayed a few days in Abu Dhabi and visited UK-listed company **Gulf Marine Services** (LSE:GMS). The investment case for GMS, a provider of support vessels for the offshore oil and gas industry, hinges on a recovery in the utilisation rate of its fleet (see June 2018 Quarterly Report). Gulf Marine's focus on maintenance services rather than construction projects mean an improvement in utilisation was largely expected. The timing of it, though, was uncertain.

The supply and demand dynamics are looking increasingly supportive of an oil price sustainably above US$70 per barrel. Production out of Venezuela, until recently one of the world's largest producers, is collapsing and unlikely to recover. Iranian exports are being severely curtailed by US sanctions on purchasing oil from that country. And there is evidence that US shale producers are unable to increase output as rapidly as previously expected.

Which leaves Russia and the low cost middle eastern producers, particularly Saudi Arabia and the United Arab Emirates, to meet the world's growing demand for oil. National oil companies from the latter two countries are GMS's largest clients.

Table 2: Gulf Marine Services—Confirmed Contracts

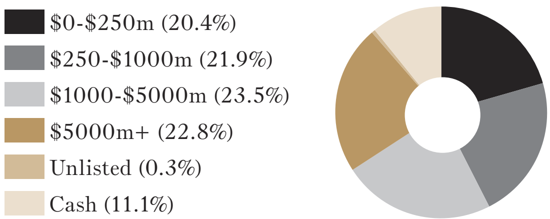


Source: Company announcements, Forager estimates
*Including options

Not only are they under extreme external pressure to turn on the taps, public commentary suggests internal resistance to further increases in prices. To increase production, though, they need to spend money.

In September Gulf Marine announced new five year contracts for three of its 12 vessels, probably with ADNOC, the UAE's national oil company. These contracts for small and mid-sized class vessels more than double the company's secured backlog and will help to reduce the current net debt balance of US$410m.

Chart 8: Portfolio Distribution According to Market Capitalisation



Both ADNOC and Saudi Aramco have tenders out for more vessels and the current fleet is likely to be close to fully utilised if GMS wins a role.

Day rates on the new contracts are still low relative to historical levels, but increasing vessel utilisation alone should prove enough to justify paying close to book value for the company, which still currently trades at a 50% discount to that. Gulf Marine is now 5.5% of the Fund's assets.

Chart 9: Stock Exposure by Geography

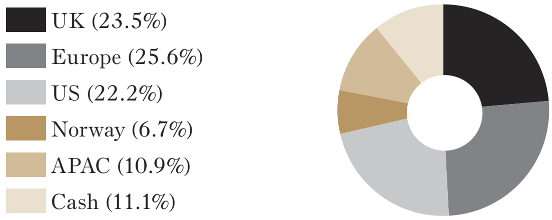


Table 3: Top 5 Investments

Blancco Technology Group Plc	7.3%
Auto Trader Group Plc	5.6%
Just Group plc	5.5%
Gulf Marine Services Plc	5.5%
Alphabet Inc	5.5%
Cash	11.1%

PORTFOLIO NEWS

At the end of last year, loudspeaker components manufacturer **B&C Speakers** (BIT:BEC) acquired *Eighteen Sound*, a small competitor also based in Italy. Excluding the impact of this transaction, B&C's second quarter sales increased 10% compared to the same period last year to €11.8m. Net profit was up 33% to €2m. The order book has grown 17% since January, so the company should continue to increase sales. *Eighteen Sound* is not yet contributing to profits. This will likely change over the coming months thanks to cost savings from an improved supply chain. B&C trades at a forecast price to earnings ratio of about 18 and offers a 3.5% dividend yield. It now accounts for 2.3% of the portfolio.

Real estate agent **Hopefluent** (SEHK:733) reported revenues of CNY1.5bn for the first six months of 2018, slightly down compared to last year. Commissions from the sale of brand new apartments, Hopefluent's main business, didn't increase enough to offset a decline in commissions from the sale of apartments in the secondary market. Net profit of CNY114m changed little from last year. The Chinese property market is expected to slow down meaningfully over the coming years as the government tries to stop investors from speculating on house prices. This is likely already reflected in Hopefluent's current low valuation and the Fund continues to hold its small investment in the company.

AUSTRALIAN SHARES FUND

FACTS

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

UNIT PRICE SUMMARY

Date	28 September 2018
NAV	$1.54
Market price	$1.65
Portfolio value	$172.4m

NO FREEDOM FROM ROYAL COMMISSION

Our investment in Freedom Insurance has been a major detractor from performance for the past year. While there are plenty of lessons to contemplate, the occasional large loss comes with the territory when investing in beaten-up and distressed value companies.

Table 4: Summary of Returns as at 30 September 2018

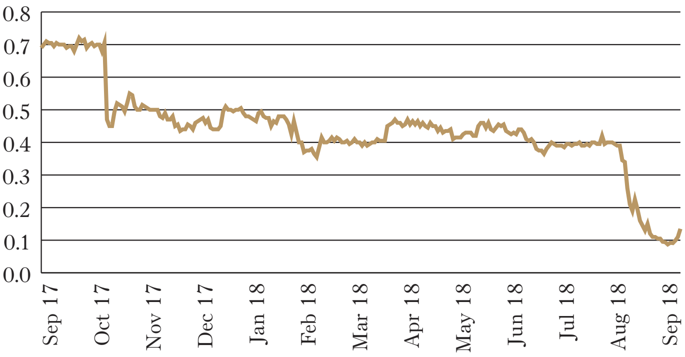
	Australian Fund (Net of fees)	S&P All Ords. Accum. Index
1 month return	-2.19%	-1.06%
3 month return	-4.64%	1.86%
6 month return	-1.11%	10.05%
1 year return	-2.43%	14.68%
3 year return (p.a.)	13.84%	12.37%
5 year return (p.a.)	11.13%	8.45%
Since inception* (p.a.)	12.85%	8.05%

*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.

FREEDOM GONE BAD

Freedom Insurance (FIG) has cost the Australian Share Fund 5.3% in performance over the last year and is down 80% from our average purchase price. After a horrendous Royal Commission the failings of its funeral insurance products, and the outbound phone calls used to sell them, have been laid bare. Looking back the failings seem obvious. So what were we doing owning the stock?

Chart 10: Freedom Insurance—1 Year Share Price ($)



Source: S&P Capital IQ

All investors make mistakes. Most successful investors say the best you can expect is to get six or seven out of 10 right. That's been consistent with our experience. The difference as a value investor is that you get things wrong in ways that are obvious, seemingly stupid and embarrassing.

Freedom sells funeral insurance policies over the phone. Over three days in late August that business model unwound in a whirlwind of regulatory scrutiny.

First, on August 28th Freedom was listed to appear in the Royal Commission's insurance hearings. The commission had already found significant misconduct in almost all other areas of financial services. It now turned its substantial powers to insurance.

The next day, a set of financial results for the last financial year were released. Now overshadowed by what was to come, the results were opaque, but not disastrous.

On the 30th of August, the Australian Securities and Investments Commission (ASIC) released a paper reviewing the state of the direct insurance industry. Despite being excluded from the review, funeral insurance, Freedom's most important product, was then included in the paper's conclusions. And the recommendations were dire for Freedom's business model: ASIC announced an intention to restrict outbound phone sales of life and funeral insurance.

When hearings were held a few weeks later the Royal Commission uncovered some appalling cases of inappropriate selling, a lax internal compliance culture and an overly difficult policy cancellation process.

While we didn't know the specifics, Forager made the investment knowing that Freedom's sales model was potentially flawed. Here's what we wrote in our research document in November last year:

"The direct sales business model could come under threat… There's something ugly about phone sales of insurance product and I can imagine it getting a lot more scrutiny if it continues to grow. I would put the probability at low but meaningful and the impact very high."

A probability assessment of "low" can be debated. The point is that we made the investment knowing full well that there was a chance of something very bad happening. But we thought there was enough potential upside to compensate for that risk and that there was some downside protection in the company's existing customer base.

That risk became reality. And when a risk that everyone was worried about comes to the fore, the nuance of chance and probability gets lost. It simply looks like we failed to understand something that was blatantly obvious to everyone else.

The downside protection part of the original thesis is about to be put to the test. Freedom has stopped selling new policies and cut costs back sharply. The trail asset, the value of future cashflows the business is due to receive from policies already

"THE DIFFERENCE AS A VALUE INVESTOR IS THAT YOU GET THINGS WRONG IN WAYS THAT ARE OBVIOUS, SEEMINGLY STUPID AND EMBARRASSING."

sold, was valued on the books at about $0.26 per share. Between potential actions by ASIC, higher cancellation rates and the need to run a cost base to realise that asset there is not much chance it is worth that now.

At $0.09 per share market expectations are for a significant impairment to the value of that trail asset. We are waiting to see how the company will attempt to maximise its value. Freedom remains in the portfolio at a 1.5% weighting; about 12% of the company's shares.

So what can we learn from this painful experience?

Is it to only invest in companies selling highly ethical products? We have no plans to introduce an ethical filter over our investments. Given what we have seen over the past few months, an ethical filter would exclude most financial services companies, plenty of miners and a host of other industrial companies. It would have also excluded online lottery ticket seller **Jumbo Interactive** (JIN), one of the Fund's most successful investments.

But there are other lessons. For one, Freedom was young, starting operations in only 2009. Net revenue grew quickly from $12m in 2014 to $64m in 2018. Quick growth probably increased the risk that internal controls were not up to scratch.

Another is that regulatory risk can impact a business very quickly and often dramatically. Aged care providers like **Estia** (EHE) have lost more than 20% of their market value since the announcement of the Aged Care Royal Commission last month. And hearings haven't even begun.

Also, our investment in Freedom was probably too large. With regulatory scrutiny of the sector, and the sensitive nature of the company's products and selling methods, perhaps a smaller position was warranted. This is, of course, an easy point to make in hindsight.

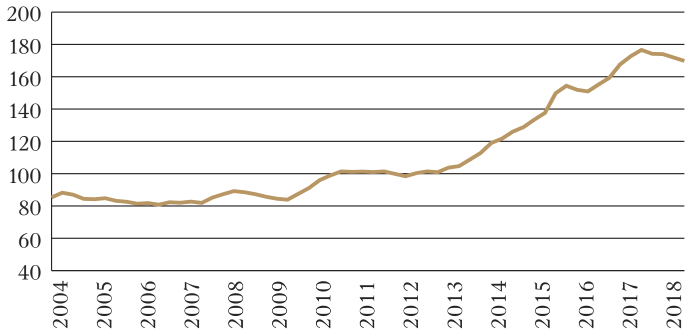
We will take what lessons we can from Freedom and apply these to other portfolio investments and potential new opportunities. But that won't stop us from taking on risk and, inevitably, losing money from time to time. It's part of investing. And it's particularly part of investing in beaten-up and distressed value companies. Forager has been successfully investing in these sorts of companies for a decade. The occasional large loss comes with the territory.

PREPARING FOR, NOT PREDICTING, THE HOUSING CRASH

Newspaper headlines like "House prices continue to tumble nationally" are now everywhere. While we have been worried about the potential for a housing correction for a long time, what was theoretical has become actual. Prices are down and it's no longer the fringe doom-sayers that are predicting further falls. It could get a lot uglier. Or it could be mild. As with many other big risks, it pays to prepare, not predict.

For a start many property owners think prices go only one way. And they had been right. National residential property prices have risen a little over 7% per year over the last 30 years. Sydney and Melbourne have risen even faster; Sydney property prices were up 74% in the five years to June 2017.

Chart 11: Sydney House Price Index



Source: Australian Bureau of Statistics

Leverage has also helped, making the return on the homeowner's equity much higher. And in the rush to buy property, owners have been taking on more debt: household debt to income has climbed to an astonishing 190% from 160% five years ago. Fortunes have been made by owner-occupiers, investors and developers.

But, as you'll find on any disclaimer: past performance is not an indicator of future performance. And things have changed.

Higher prices finally brought in new supply. Apartment construction approvals doubled in the five years to 2016 and are still elevated. Those apartments have been coming onto the market over the past year. Vacancy rates in Sydney are the highest in 13 years and rents are down.

Then the pin was pulled on the debt grenade. The Royal Commission showed that banks have been basing their lending assumptions on unrealistic customer living expenses. Loans are now harder to get. And the amount of credit being provided has been reduced meaningfully. In a recent UBS podcast, their banking analyst Jonathan Mott explained why this is so important:

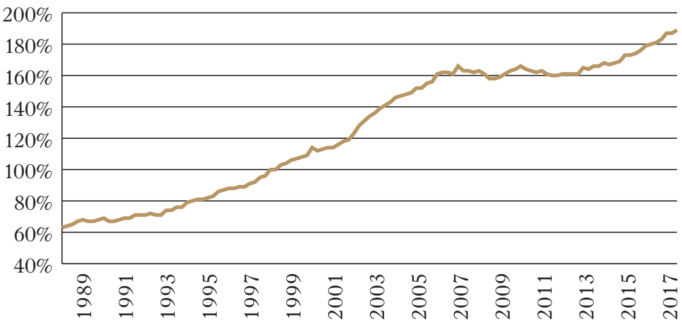
"House prices are not driven by the demand and supply of housing and population growth. Maybe on a 20-year time frame they are. House prices are determined by the demand and supply of credit availability. When you take your hand

“PRICES ARE DOWN AND IT’S NO LONGER THE FRINGE DOOM-SAYERS THAT ARE PREDICTING FURTHER FALLS. IT COULD GET A LOT UGLIER. OR IT COULD BE MILD. AS WITH MANY OTHER BIG RISKS, IT PAYS TO PREPARE, NOT PREDICT.”

down at the auction is when you run out of money. And if the banks aren’t lending you as much as they did 12 months ago, well your hand comes down a couple of hundred grand lower”.

High debt-to-income and interest-only borrowers, mostly investors, are in the most trouble. They are squeezed by higher borrowing costs, more principal repayments, and fewer opportunities to refinance.

Chart 12: Household Debt to Income



Source: Australian Bureau of Statistics

And then there’s the big one. That psychological X factor. Will buyers sacrifice avocado on toast to own a home? Does the comfort of owning a home outweigh the freedom of being mortgage free? Will the emotional attachment to home ownership fade? While hard to pinpoint, this factor will dictate whether a 10% to 15% correction becomes something far more significant.

ANZ (ANZ) and **Commonwealth Bank** (CBA) have now both pegged their forecasts on a peak to trough 10% fall. With a couple of hundred billion dollars of mortgages on their books there are plenty of reasons for them to be artificially optimistic. More bearish predictions have property prices falling 30% to 40%, more likely in the hot markets of Sydney and Melbourne. Disaster. But let’s keep it in perspective. A fall of 40% in Sydney would take prices back to mid-2013. That’s not exactly ancient history.

We are not predicting disaster or salvation. Instead we are trying to be prepared with a portfolio of stocks that can deal with a bad outcome. So what happens to listed businesses if property prices fall sharply from here?

Starting with the big banks. It’s a tale of higher compliance costs, lower credit growth and higher bad debts. Increased compliance cost the Commonwealth Bank another $400m last year. Credit growth has slowed, mostly due to property investors stepping back from the market. Bad debts are still at very low levels, but with arrears increasing it might not be long before mortgages start to go bad.

Mortgage brokers are next. New lending has slowed. And attracting and retaining brokers has become more difficult. **Mortgage Choice** (MOC) has recently started paying more to its brokers to stem departures. It’s a tough space and one that would be most affected if the worst occurs. Forager’s exposure to banks and mortgage brokers is zero.

But those are just the most obvious effects. It would spill over from there and investors should not underestimate how important the residential property asset class is to Australia.

For a start lower house prices would mean lower consumer confidence. Those comfortable buying a $5,000 couch from **Nick Scali** (NCK) when their house price rose by $100,000 last year might shudder to do the same when they are looking at a $100,000 loss.

A loss of consumer confidence would see **Harvey Norman** (HVN) sell fewer $5,000 4K TVs too. And a tightening budget could mean fewer overseas trips: watch out **Flight Centre** (FLT) and **Webjet** (WEB).

And what about one of the biggest discretionary purchases: a new car? Well new vehicle sales last month were down 5.5% from last year. If house prices keep falling it won’t get any better for **AP Eagers** (APE) or **Automotive Holdings** (AHG). Salary packaging and novated lease companies like **Eclipx** (ECX) would also be in trouble. Forager’s exposure to these two sectors is also zero.

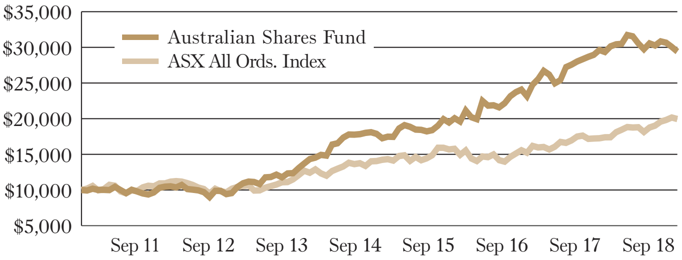
It could also mean less access to credit for smaller companies, as banks start being more cautious across all loans. Small business lenders like **Silverchef** (SIV) and **Axsesstoday** (AXL) are already in trouble with higher arrears in their own lending books. Less access to credit and tough times for their customers could make life for these companies, and other highly leveraged businesses, even harder.

Here we do have some exposure. **Thorn** (TGA) would suffer if credit was withdrawn from its equipment finance division, although its consumer division could be one of a small number of beneficiaries. **CSG** (CSV) would also struggle collecting payments from its small business clients. Others, like **MMA Offshore** (MRM) carry debt, but are less susceptible to domestic issues.

There are also negative implications for the Australian dollar. Portfolio companies earning money in foreign currencies, like **Macmahon** (MAH), **Matrix** (MCE) or **Enero** (EGG), could actually be better off. In fact, we would argue foreign currency diversification is probably the best protection you can buy.

There are plenty of reasons to think that the future for residential property in Australia is not going to be rosy. But just how bad it gets is hard to quantify. As we do with other big risks, it's less about predicting the outcome, and more about being prepared if the worst does happen.

Chart 13: 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 14: Portfolio Distribution According to Market Capitalisation

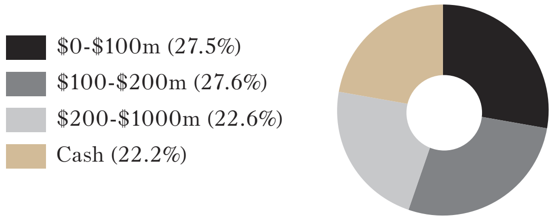


Table 5: Top 5 Investments

Macmahon Holdings Limited	12.4%
Enero Group Limited	9.1%
iSelect Limited	7.7%
MMA Offshore Limited	5.7%
Thorn Group Limited	5.4%
Cash	22.2%

PORTFOLIO NEWS

During the quarter the **Forager Australian Shares Fund** (FOR) completed a one for six rights issue, raising $20.3m. During the national roadshow in July many investors asked how they could increase their investment in the Fund. With a unit price trading at a large premium to net tangible assets (NTA) we urged caution; paying a substantial premium would impede long term returns. The rights offer was priced at NTA when it was announced, and gave investors an opportunity to apply for their entitlement and additional units. We would like to thank investors who participated.

Forager had also been managing a smaller second fund alongside the Australian Shares Fund. When we resigned from managing that fund in June capacity was made available to Australian Shares Fund unit holders through the rights issue. The amount raised was then applied to purchasing the portfolio of this other fund, totalling about $18.8m. The two portfolios were substantially the same, allowing us to quickly deploy funds from the rights issue into stocks we already owned.

So Forager now manages a single Australian shares fund with assets of $172m. Cash at the end of September was about 22% of the portfolio. We continue to believe that $200m is the natural capacity limit for the Australian shares investment strategy.

Matrix Composites and Engineering (MCE), manufacturer of oil and gas equipment, delivered a result in-line with its August trading update. Revenues and earnings are down from the previous year, but the outlook is beginning to improve. Oil and gas development quotation activity has picked up, with oil prices at their highest levels since the end of 2014. Matrix's competitive position also continues to strengthen as competitors exit the market and reduce their capacity. There is also some potential for new products to gain traction. Matrix remains a cheap option on the long term recovery of offshore oil and gas spend.

MSL Solutions (MPW), an enterprise software provider for sport, leisure and hospitality venues, continues to expand internationally and grow its recurring annuity revenue base. Organic revenue growth was strong at 20% for the year, with acquisitions contributing another 24%. These have increased their geographic reach and the number of modules MSL can offer its customers. "Adjusted" net income fell just short of prospectus forecasts but curiously excluded one-off expenses and included one-off revenues. We hope to see management communicating more clearly with investors in the next set of financial results.

A number of growth initiatives are underway for administration business **Mainstream Group** (MAI) after completing a $9.5m capital raising in September. The proceeds will be used to fund the capital base required to operate a custody service, invest in a wealth management platform and expand into the US. The capital raising was accompanied by a sell down from the Chairman and the Managing Director. Mainstream reaffirmed its positive outlook, with the same revenue and earnings targets as expected earlier in June despite losing a small client due to a merger.

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