March Quarterly Report

MACRO CAPITAL LIMITED
ABN 14 145 321 928 | AFSL: 392401

GANES INVESTMENT MANAGEMENT PTY LTD
ABN 86 113 032 741 | AFSL 287598

Market Returns and Portfolio Performance

Performance 31-Mar-18	Ganes	All Ord Index
1 Month	-0.52%	-3.55%
3 Month	0.21%	-3.69%
6 Month	10.59%	4.20%
1 Year	22.51%	3.65%
2 Year (p.a.)	17.81%	11.29%
3 Year (p.a.)	10.67%	4.43%
5 Year (p.a.)	9.92%	7.86%
10 Year (p.a.)	8.81%	5.28%
Since Inception (p.a.)*	8.57%	6.47%
NAV Unit Price ($)	1.8348	
Fund Assets ($ million)	27.75	

* Inception date of Fund 18/11/2005

For the 12 months ending 31st March, the Fund return was 22.5% versus 3.65% for the benchmark All Ordinaries Index, representing a relative outperformance of 18.9%. We reiterate that outperformance over such a short period has as much to do with market sentiment as the investment manager's skills. Smaller companies have been back in favour and the Fund is a beneficiary of this market sentiment.

Over our preferred time frame of 5 years the Fund return was 9.9% per annum versus 7.9% per annum for the All Ordinaries Index, representing an outperformance of 2.0%. Investors should recognise that Fund returns are net of all fees, while the Index does not incur any fees. Our goal is to beat the index after fees over this timeframe.

Since inception in November 2005, the Fund has returned 8.6% per annum versus 6.5% per annum for the All Ordinaries Index representing an outperformance of 2.1%. While the outperformance may appear small as a percentage number, it is surprising how much this adds to an investment with the benefit of compound interest over long periods of time. For example, the 3.5% outperformance for a decade that the Fund has achieved, results in the starting investment being nearly 40% greater at the end.

We should also state that while the All Ordinaries is presented as the benchmark for the Fund, the portfolio bears no resemblance to the Index, as the manager actively seeks out smaller companies for the portfolio and avoids resource companies. If we were to compare Fund performance against the Small Ordinaries Index instead, it has beaten this index by 3.4% per annum over the past 5 years and 7.4% per annum over the past decade.

This highlights that Australia's largest companies, and banks in particular, play a big role in determining Australia's broader market returns. In fact, the Small Ordinaries, which excludes the banks, has delivered a bare 1% per annum return for the past decade while the largest bank, the Commonwealth Bank, has delivered more than 11% per annum over the same period.

Why the Business is as Important as the Yield

The reason for the popularity of the banks lies largely with their generous dividend policy, and likewise for Telstra, which was offering a dividend yield of around 7% last year. However, chasing dividend yield without considering the underlying business as an investment can be a fraught experience for investors. Telstra shareholders chasing dividend yield have endured the unsettling experience of seeing the share price fall by 31% over the last year and now face reduced dividends due to the competitive pressures and capital expenditure requirements of the business, curbing the ability of the company to maintain its dividend.

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Pricing Power

Retailers, and more specifically Myer, has also come under pressure in recent months, as it has announced profit downgrades, lost its CEO, received sustained media agitation by a large minority shareholder and more recently speculation as to whether it could breach its banking covenants this year. From an iconic Australian retailer for the past century, the company now has a market capitalisation of just over $300m, less than that of Beacon Lighting, one of our small cap holdings.

This turn of events highlights that every company, regardless of its heritage, needs a competitive advantage in order to survive over the longer term, let alone provide attractive returns for its shareholders. Warren Buffett has said the ability of a business to raise prices tells you a lot about the strength of the business. On that metric retailing is a tough business with low barriers to entry and little pricing power especially for those selling branded goods. The disintermediation of the customer, highlighted by the emergence of Amazon and eBay, has only added to the competitive pressures.

Consequently, we only have two investments in this sector, **Nick Scali** and **Beacon Lighting**. Both these businesses sell a product where they control the design and distribution of their product which provides a small, and we emphasise small, barrier to entry, but most importantly are led by large founding shareholders who have always acted in the best interests of the shareholders.

Portfolio Performance

There has been little in the way of portfolio activity over the past quarter, or even the past year. During March, we slightly reduced our exposure to **Clydesdale Bank** while adding slightly to **PWR Holdings** following its half year result.

As has been noted above, the Fund has enjoyed strong performance in recent times outperforming the broader market by a considerable margin. The portfolio is very concentrated by market standards with the top 10 holdings now representing more than 70% of the Fund. This is more concentrated than usual by our standards and has come about largely through price appreciation, as nearly all our top 10 holdings delivered strong price appreciation over the past year.

In general terms, our best ideas tend to be our biggest positions and as such our outperformance, or underperformance at times, will depend largely on the returns of these few select stocks. We retain confidence in the Fund’s largest holdings, however we can never predict what will happen in the future. We can say that after a period of subdued performance our larger holdings have taken off again in recent times with some of the largest positions experiencing significant price increases.

Smartgroup

Smartgroup remains the Fund’s largest holding and the largest contributor to recent Fund performance. The Fund invested in the salary packaging provider in April 2015 at $1.70 and we have been pleased to watch the outstanding progress of the company since then. The company has grown from revenues of $72m, profits of $17m and managing packages for 118,000 clients in 2014 to recently reporting revenue of $205m, profits of $64m and managing 325,000 packages for customers mostly in the not-for-profit sectors and hospitals.

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The company earns attractive returns on its capital and Managing Director, Deven Billimoria, has been with the company for 18 years and has significant "skin in the game", owning over $25 million of shares in the business. These are features that we look for in a business and all too rarely find.

MFF Capital

Magellan Capital is a listed investment company that holds a portfolio of international investments and has provided a 15% return over the past decade, making it one of our better performers in the portfolio. The share price has risen 24% in the past year, largely in line with the asset backing (NTA) which has risen 20% from $2.12 to $2.55 during the same period.

The portfolio continues to consist of large holdings in Visa, Mastercard and Home Depot which are wonderful businesses that have no equivalent in Australia. At present, the shares are selling in line with NTA and MFF remains a core holding in the Fund.

ARB Corporation

ARB, a core holding in the Fund since inception, also contributed strongly to Fund performance with the shares up 37% over the past year. ARB is a wonderful business, and this is reflected in the 22% return per annum delivered over the past decade despite the GFC. However, the underlying business itself has not improved by 30% in the past year, and hence ARB is very typical of why the Fund can produce returns very different to the market over the short term but returns consistent with underlying business performance over the longer term.

ARB has consistently grown sales and profits at 10% to 15% and consequently the underlying business has improved at something akin to its growth, however in any given year its share price has moved something in the nature of 40% either up, and sometimes down. As long-term term investors who wish to benefit from the underlying improvements in the business, we need to have the temperament and patience to ignore the short-term volatility inherent in stock markets. We have some visibility over future business performance, but we have yet to find anyone that can predict share prices on a successful basis.

Looking at the first half results released in February, sales were up 12% to $208m and pre-tax profits rose nearly 11% to $35.7million. The company opened another 3 new stores and 3 more stores are expected to be opened in the second half bringing the store network to 64 stores, of which 25 are company owned.

To highlight the unpredictable nature of share prices and short-term volatility, we only need to look at the picture this time last year when the company's profit result, of largely the same magnitude, underwhelmed the market and the price fell 20% from its highs in September 2016. This year, the market liked the result and the share price rose 10% following the announcement which only goes to reinforce that investors should concentrate on the business and not unpredictable share price movements.

The business has confirmed that 2018 has continued strongly and we continue to like the company's prospects over the medium to longer term and the company remains a core holding in the portfolio.

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Cochlear

The healthcare sector has enjoyed a stellar year and Cochlear has done likewise with the share price up 36% for the past year and similar to our other good quality companies, has delivered 16% per annum for the past decade despite the dramas of a product recall in 2011.

The company recently released its half year results and while the company continued to achieve good results in developed markets, lack of growth in emerging markets took the gloss off the headline numbers. Sales revenue was up 6%, Earnings Before Interest and Tax increased 3% while profits were flat. These headline numbers mask a great underlying business as the company expenses $160m each year on Research & Development developing its products and still earns attractive profit margins of 25% at the operational level.

The company has invested $50m in China to develop production facilities and expand on its 20-year presence in the country and also continues to develop its Services division which targets existing customers and now accounts for approximately 25% of its revenues.

On our estimates, the share price has increased far more than the underlying business over the past year and doesn't represent compelling value, but we are loath to sell and incur significant capital gains and miss out on the future growth in the business for a short-term perspective.

Gentrack

New Zealand based Gentrack bills itself as 'essential software for essential services'. This means it provides business critical software for airports and the water utilities industries. The arrivals and destinations boards at the airport are an example of their software that unitholders might see, although billing systems for water utilities makes up the most of the company's business providing more than 80% of its revenue and profits. The company sources 65% of its revenue from Australia and New Zealand, with the balance coming from overseas (mostly the UK).

Business critical software can provide extremely good economics and build strong pricing power as the cost of switching providers is extremely costly in time, effort and money for often not much benefit. Shareholders in Hansen Technologies have also benefited from this type of business, which is what alerted us to Gentrack in 2015.

The share price has risen 80% in the past year making Gentrack another large contributor to Fund.

Current Activity and Outlook

We have constructed a portfolio that we believe constitute a range of good quality businesses providing good returns on capital with attractive growth opportunities. With the recent strong run up in price for some companies, the value is not as compelling as last year but we are content to take a long-term approach and reap the benefits of being a patient investor despite unpredictable price fluctuations over the short term.

As in previous years, the Fund will pay a distribution for the quarter. The March distribution is 0.6537 cents per unit for the quarter.

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