September Quarterly Report

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

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

Markets

Performance 30-Sep-18	Ganes	All Ord Index
1 Month	-2.74%	-1.06%
3 Month	0.35%	1.86%
6 Month	8.61%	10.05%
1 Year	20.11%	14.68%
2 Year (p.a.)	15.08%	11.56%
3 Year (p.a.)	15.94%	12.37%
5 Year (p.a.)	10.40%	8.45%
10 Year (p.a.)	11.10%	7.71%
Since Inception (p.a.)*	8.92%	7.00%
NAV Unit Price ($)	1.8404	
Fund Assets ($ million)	26.04	

* Inception date of Fund 18/11/2005

The local market fell 1% in September but despite this has posted some healthy returns over the recent past, with the 6 months providing a 10% return and 14.7% for the year. Globally, the US market continues to hit record highs with many market commentators questioning how long this bull market can continue. Adding to this commentary is the 10 year anniversary of the collapse of Lehman Brothers which led to the Global Financial Crisis, providing the opportunity for many commentators to highlight the risks currently residing in many markets and asset classes.

Politics continued to provide a backdrop to news headlines but with no apparent effect at this stage. The tariff trade wars between the US and China, the ongoing Brexit saga and now the Italian government deficit all appears to have been largely ignored as global economies reported buoyant conditions and the Federal Reserve felt able to increase interest rates again during the month. The only casualty at this stage appears to be Emerging markets with the impact of a rising US dollar causing hefty falls.

Fund Performance

The Fund has continued to perform well despite reporting a negative return for September. The 1 year return is 20.1% (outperforming the market by 5.4%), but more importantly the 10 year return is 11.1%, outperforming the market by 3.4% even after all expenses are accounted for.

Much of the cause for the negative return in September was a 7% fall in the Smartgroup share price and a 10% fall in the Reece share price. There was no news that can be attributed to either fall and both companies remain key holdings in the Fund.

After many months and years of good performance, we tend to ignore this short-term price volatility which is usually unaccompanied by any fundamental change to the business. For example, despite the 10% fall for Reece in September, it has still delivered a return of nearly 30% for the past year and 15% for the past decade – almost double that of the general market. It is a similar story for Smartgroup and hence we only report these movements to explain performance rather than act upon them.

Fear of Missing Out

In the current market there are many smaller companies that have reported stellar returns for shareholders including companies such as Afterpay, A2 milk and Appen. We have not owned any of these businesses and hence have missed out on these outsized returns, but as we have written previously, a lot of investment success is about not making mistakes rather than hitting big winners. In this instance, we looked at each of the companies and felt that we did not understand the business and its prospects well enough to invest your money in the company.

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We invest in businesses we think we understand, and we think will offer attractive returns in the future. This means that we will miss some of these opportunities but that does not worry us one bit, nor should it worry unitholders. Fear of missing out and investing in companies that are outside the investor's circle of competence increases risks significantly while not necessarily increasing the returns for investors.

Quality Suits our Temperament

We have written many times that we invest in good quality businesses and this has not changed one iota since we started. We have long advocated buying quality companies rather than any other path – that is not to say it's the most successful, but that it more closely matches our temperament as investors – and it has shown in our investment results, particularly over the longer term as the economics of the business becomes more important than short term share price movements.

We have found that good quality companies provide the least headaches to their shareholders, a more predictable future, and the ability to remain as long-term shareholders – as examples, the Fund has owned shares in Reece, ARB Corporation and MFF Capital for more than a decade.

Quality businesses have generally created a competitive advantage in their market over many years and this competitive advantage is usually hard to destroy quickly, providing attractive returns for shareholders. However, companies with little or no competitive advantage and no pricing power tend to provide miserable long-term results for shareholders and management become adept at providing a never-ending array of excuses as to why the current results are poor but next year's will be better. At various times, these types of companies will become so cheap or market conditions will temporarily change creating some short term favourable trading conditions, that offer attractive returns.

However, investors need to have both the temperament and the skill to recognise these turning points before they can expect to achieve good investment results. For many, however, they can also be what are known as 'value traps' where the business always looks cheap and eventually the poor underlying economics of the business come to the fore again and investors earn poor returns in tandem with the business. We have long recognised that this style of investing does not suit us and hence why the portfolio consists of what we believe are 'quality' companies. While they can sometimes appear expensive in the short-term we have usually found that the business value catches up to the share price and will often provide a favourable surprise along the way.

Portfolio Review

Profit reporting season was generally good for the portfolio and below we highlight some salient points from the larger holdings in the Fund.

Smartgroup has enjoyed another good year and has been the strongest performer in the portfolio since its purchase in mid 2015 and remains the largest holding in the Fund. The company reported another strong half year result with revenue increasing by 26%, profits by a similar amount and the dividend increasing by 24%. The company continues to execute well on its acquisition and growth strategies and now manages more than 330,000 salary packages more than doubling in the past few years.

MFF Capital Investments generated a strong year with the pre-tax NTA for the company increasing by more than 30%, partly as a result of the weaker Australian dollar, and has increased a further 10% in the latest quarter as its exposure to the US market provides a strong tailwind. MFF is one of the best performers in the Fund with a 40% return over the past year and an 18% per annum return over the past decade, well ahead of local markets. Its portfolio remains largely unchanged with large positions in Visa, Mastercard and Home Depot.

ARB Corporation reported a solid year with revenue climbing 11% to $426m and pre-tax profits up a similar amount. Dividends were increased by 9%. Pleasingly, export sales were up 15% and comprise 28% of total revenue. This is a key component for the growth of the business in markets such as the USA and the United Arab Emirates where 4WD vehicles are becoming increasingly popular. Growth for the company has slowed since the heady days of the mining boom but nevertheless it still is reporting record results as it continues to expand. The share price has pulled back slightly from its record highs but remains a core holding in the Fund.

PWR Holdings also reported a solid result for 2018 with revenues rising 8% to $52m and net profit up 30% to $12m. But perhaps more importantly for the business, their major competitor has announced it is withdrawing from the F1 business which should provide big opportunities for the company in FY19 and beyond.

Led by founder Kees Weel, the main part of the business remains cooling systems for auto sports, with an emphasis on Formula 1. However, in the future other areas such as niche contracts for car manufacturers and emerging technologies such as cooling systems for electric cars will also add to the bottom line for shareholders. We like the business, management is strong and growth prospects are good. The share price has risen strongly in recent months and has contributed to Fund performance due to its high portfolio weighting.

Outlook and Distribution

With the strong performance of the market for the past few years, and with little prospect for any significant rise in local interest rates in the near term, it seems fair to conclude that at current levels the overall market appears neither particularly cheap nor expensive on a general level, although that varies widely at a stock level.

We remain optimistic about the future prospects of the portfolio of businesses held by the Fund and this continues to be reflected in the fully invested position of the Fund, however the recent strong performance has outpaced the underlying performance of many of the businesses so future short-term returns could be muted without specific news to support the higher share prices. The portfolio comprises a mixture of companies with motivated and innovative managers, good revenue and profit growth potential, as well as strong balance sheets and healthy cash flow.

The September distribution of 3.1442 cents per unit is higher than in previous years due to the realisation of capital gains that will be paid this quarter. In previous years, all capital gains have been distributed in the final June distribution, however, it is planned that capital gains realised during the year will be paid on a more even basis during the course of the year which could see higher distributions during the year but a lower final distribution in June.