APRIL 2019 MONTHLY REPORT

Market Returns and Portfolio Performance

The Australian market has produced a positive return of 2.5% for April. After the dramatic fall of nearly 10% in the December quarter the market has bounced back with four straight positive months. The local market has followed the US market higher rebounding on the back of the US Federal Reserve's decision to put interest rate rises on hold for the foreseeable future.

Performance 30-Apr-2019	Ganes Value Growth Fund	All Ord Index
1 month	5.8%	2.5%
3 months	6.0%	9.5%
6 months	1.1%	10.8%
12 months	0.8%	10.2%
2 years p.a.	11.0%	8.3%
3 years p.a.	12.2%	11.0%
5 years p.a.	8.4%	7.8%
10 years p.a.	12.3%	10.1%
Since Inception (p.a.)*	8.1%	7.0%
NAV Mid Unit Price ($)	$1.6511	
Fund Assets ($ million)	$20.53	

*Inception date of Fund is 18/11/2005

The rising local market comes even though Australia faces its own set of challenges with a housing market that continues to weaken, a highly indebted population, constrained bank lending, and a looming Federal election that could see some significant changes to the economic landscape if a new labor government is elected.

For the quarter ending 30th April the Fund return is 6.0% versus 9.5% for the benchmark All Ordinaries Index, representing a relative underperformance of 3.5%. We reiterate that performance over such a short period has as much to do with market sentiment as the investment manager's skills. Large mining companies such as BHP and Rio Tinto have been back in favour in recent months and the fund has no exposure to this element of the market. The portfolio hasn't had any disasters, but it hasn't enjoyed the buoyant share price movements that some sectors, such as resources, have delivered either.

Over our preferred time frame of 5 years the Fund return was 8.4% per annum versus 7.8% per annum for the All Ordinaries Index representing out-performance of 0.6% per annum. 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.

The main reason for the relative underperformance over the short term is the poor share price performance of several larger holdings. Currently, the top 10 holdings represent 85% of the Fund which is more concentrated than usual and has come about through the price appreciation of the larger holdings and sales of some smaller positions. In recent months three of our top holdings, ARB Corporation, Smartgroup and Gentrack have all suffered share price falls that have nearly wiped out the collective gains of the rest of the portfolio.

Just over 12 months ago, when we had just outperformed the market by nearly 19% in one year, we wrote the following:

"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."

As it turns out, and we suspected at the time, some of the significant price increases were not justified by the growth of the underlying businesses and as the companies have since reported their financial results their prices have fallen back to reasonable levels.

Why didn't we sell when the prices were higher? With the benefit of hindsight that is a valid question, however, our experience has been that strong businesses continue to grow, and investment returns accrue with the compounding growth. Identifying these types of businesses is difficult and, in our opinion, there are few of them in Australia. By attempting to trade in and out of these businesses investors are triggering capital gains, an explicit cost to investors. Equally they can be triggering implicit costs such as emotional biases as it becomes hard to buy back into these businesses if the price fails to fall, or more usually the case, fails to fall enough that it becomes attractive to buy again and investors then miss out on the long term potential of the business.

In the case of ARB Corporation, Smartgroup and Gentrack, these companies have all been owned for a number of years, and in the case of ARB for more than 10 years and have provided very good returns for investors while we have owned them – ARB has delivered over 23% per annum for the past decade despite the ups and downs and various challenges the company has faced. These are all businesses that earn high rates of return on capital and are quite profitable, however, they had become quite expensive by traditional metrics during the course of last year. Since June their share prices have fallen around 20% each reflecting a more conservative, and perhaps now more appropriate, outlook for the businesses.

Portfolio Commentary

With the recent reporting season now finalised we can generally say that most companies within the portfolio delivered as expected with few disappointments but equally few positive surprises. Following is a brief summary for the largest holdings within the portfolio.

MFF Capital

With the fall in the Smartgroup share price MFF Capital has become the fund's largest holding. It is a listed investment company that holds a portfolio of international investments and has provided a solid 20% return per annum over the past decade making it one of our better performers. In the latest quarter the pre-tax NTA has risen to $3.22 from $2.61 a year ago – a gain of 23%. The share price has risen 26% slightly exceeding the underlying gain but still in line with the NTA as the previous discount has disappeared.

The MFF portfolio is quite concentrated and continues to consist of large holdings in Visa and Mastercard which are two high quality global businesses that have no equivalent in Australia. At the end of March these two businesses represented around 30% of the fund and 77% of the fund is invested in its top 10. At present the shares are selling at a discount to the pre-tax NTA and MFF remains a core holding in the Fund.

PWR Holdings

PWR Holdings has become the fund's second largest holding as its price has increased significantly over the last year with 70% total shareholder return. PWR is a very seasonal business with about 75% of its profits earned between January and June as the Formula 1 and northern hemisphere motor racing seasons take place, so its first half results to December are somewhat meaningless as a guide to full year profitability.

Revenue was up 22% on last year, profits were up 16% on a comparable basis and the dividend was increased by 46%. All headline numbers that appealed to investors but more importantly to us, the company continues to make good progress growing its business. It has opened a new production facility in the USA and expanded its local production capacity which should help manage supply chain and currency issues and deal with the production orders that will flow through in to the 2020 financial year. We are also led to believe that with the withdrawal of their major competitor in F1 this should deliver an additional 10% to 20% of revenue growth for the business in the next year or so.

PWR remains debt free and earns very attractive profit margins. With good pricing power and limited competition PWR is an attractive business and we remain confident in its future.

ARB Corporation

ARB, a core holding in the Fund since inception, has seen its share price fall heavily since the middle of last year after rising 37% in the previous year. One would think that some fundamental changes within the business must have occurred to generate this level of volatility, but no, this is the inherent risk of investing in the sharemarket. New car sales have fallen over the past year, so we suspect that ARB is getting caught up in the pessimism associated with this industry. Certainly, a buoyant car sales market is a tailwind for the company, but recent half year results suggest they are weathering the downturn as they have other downturns in the past.

We wrote last year that while the share price had risen more than 30% it was fair to say that the underlying business had not improved by this quantum and hence why fund performance can vary significantly from company performance over the short-term.

ARB has consistently grown sales and profits at 10% to 15% per annum 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 compounding improvements in the business we need to have the temperament and patience to ignore the short-term volatility in share prices.

Looking at the first half results released in February they were more subdued than what we are used to seeing. Sales were up 5% to $218m and pre-tax profits rose 5% to $37.5million. This is quite a bit below their normal growth of more than 10% and the market took the knife to the share price as a result.

Management has stated that 2019 sales have continued to grow, however economic conditions in its main markets remain unpredictable. The company is always relatively cautious but this is also more restrained than normal and probably yet another trigger for some investors to head for the exits. We have been long term owners of this business and while short-term conditions may be challenging the company believes it is well positioned to achieve on-going success. With a long track record of delivering on their promises, and the share price back in reasonable value territory, we are content to continue to own ARB as a core holding in the portfolio.

Smartgroup

After being the best performer in the portfolio for some time Smartgroup has had the biggest negative impact on performance for the past year. We first purchased the shares in April and May of 2015 at an average of $1.75 per share and the following few years of strong profit growth saw their shares peak at around $12.80 in August last year. The shares have since slid back to under $9.00 at the end of April – a decline of around 33%. Being the largest holding and falling so much has had a dramatic effect on the short term performance of the fund – in the order of 4% to 5% for the fund overall.

In the latest financial results revenue was up 18%, profits grew 22% and the dividend was increased 19% over the prior year despite a slowdown in car leasing. In the past that sort of growth was enough to keep the market happy but not lately. A slowing car retailing market, some effects from the Banking Royal Commission and lower organic growth have all taken a toll on the outlook for the business.

In addition, a couple of red flags have been raised for us. The company raised $75million of capital in February last year from institutional shareholders but has not announced any acquisitions since and has just recently announced a special dividend for shareholders, effectively returning some of that capital. That sort of capital allocation is at odds with the sensible capital decisions made previously. In addition, the Managing Director, who has recently returned from Long Service Leave, has sold a significant part of his shareholding.

The company still earns attractive returns on its capital as well as good profit margins, but it faces some challenges as organic growth is in single digits and acquisitions to boost growth are perhaps becoming harder to find. We haven't hit the exit button but the gloss has come off the business in recent times and we are readjusting our weighting accordingly.

Gentrack
Software provider, Gentrack is another company that has been a good performer for the fund until recent times, but since June last year it has fallen 19%. Even though the price rose 8% in March and 9% in April the fall has been another reason for the fund's short-term underperformance.

Gentrack's issues seem to be wrapped up in Brexit and the decision of customers to delay major projects until the issue is sorted. Looking at the financial results released at the end of last year, revenue rose 39% and profits were up 17%, and along with the addition of new customers it appeared the company was performing well. But it also warned at the time that projects might be delayed due to the Brexit issue.

This was confirmed at its recent AGM where the company stated that it expected its first half results for 2019 to be below that of 2018 as it had staffed for major projects that have been delayed. In addition, it continued its move into the software as a service (SaaS) business model which should have long-term benefits for the business as total lifecycle revenue increases under that model but comes at a short-term cost.

Some better news came with the announcement the company has expanded into the Singapore electricity market providing software to 3 energy suppliers as their market deregulates.

<u>Current Activity and Outlook</u>

Despite the short-term underperformance against the market we remain confident the portfolio is underpinned by a range of good quality businesses providing good returns on capital with attractive growth opportunities. With the recent falls in price in some of these companies values appear more reasonable than a year ago.

The March distribution was 4.2513 cents for the quarter.

DISCLAIMER

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