GANES

FOCUSED VALUE FUND

APIR GCM0001AU | ARSN 117 119 712

DECEMBER 2019 QUARTER REPORT

Portfolio Performance

The fund has experienced a relatively poor quarter with the unit price falling 3.0% to $3.36, but on a positive note has delivered a return of 20.8% for the past year and 11.5% per annum since inception.

When we wrote our update at this time last year global markets had endured a horror final three months to end 2018, and the fund had reported a negative return of 12.7% for the quarter. Twelve months later equity markets have produced unexpectedly strong results with the S&P500 rising nearly 30% for the year, marking 2019 as one of the best years for a decade. And as the table shows local markets were also up nearly 24% including dividends.

To highlight the futility of trying to predict whether markets will be up or down it is always enlightening, or simply amusing, to go back and look at forecasts from the start of the year by market “experts”. In January 2019 with very serious faces and very rational explanations many, if not all, experts were predicting bearish markets and raising their cash levels. We remind readers that we are not in the game, and it is a game, of forecasting markets and see no value to be had from trying to do so. The rule is if you are going to make forecasts then make a lot of them and make them often.

The fund remains based upon the philosophy of finding good quality businesses, world-class if possible, and holding them for the long term. If we get that right the returns should follow, although just not necessarily in line with the market all the time.

The fund remains fully invested with cash currently at less than 2% of the portfolio.

A distribution of 6.1246 cents will be paid to unitholders for the December half-year.

Performance as at 31 December 2019:

	Fund (net of fees)	ASX 300 Accum. Index
3 months	-3.0%	0.7%
1 year	20.8%	23.8%
3 years p.a.	10.7%	10.3%
5 years p.a.	9.4%	9.1%
10 years p.a.	9.3%	7.8%
Since Inception (p.a.)*	11.5%	9.3%
Value $10,000 invested since inception	$64,794	$47,417

*Inception date of Fund is 14/10/2002

Unit Prices as at 31 December (Pre-Distribution)

Entry Price	$3.3701
Unit Price	$3.3584
Exit Price	$3.3466

Top 10 Holdings:

Company	Code	Weight (%)
PWR Holdings	PWH	13.2
MFF Capital	MFF	11.5
Reece Australia	REH	9.2
Nearmap	NEA	6.7
ARB Corporation	ARB	6.1
Cochlear	COH	5.4
Smartgroup	SIQ	4.8
Dicker Data	DDR	4.8
Domino’s Pizza Enterprises	DMP	4.2
CSL	CSL	3.8

Sector Exposure:

Sector	Weight (%)
Consumer Discretionary	35.8
Financials	19.6
Information Technology	18.3
Industrials	14.0
Health Care	9.3
Cash & Other	3.0

Portfolio Update

Smartgroup
Smartgroup was the main reason for the fund's poor performance during the quarter. After rebounding strongly in the September quarter and being a major contributor to fund performance, Smartgroup has disappointed on a number of fronts during the past three months.

We attended a conference in early October where long-standing CEO, Deven Billimoria, outlined growth plans for the company, but only days later the company's major shareholder sold down its stake, and then Billimoria surprised the market announcing his retirement along with a small profit downgrade. To cap off the quarter, in mid-December the new CEO-in-waiting announced a further profit downgrade. No doubt he is clearing the decks before his appointment in February but all in all it has been a very disappointing three months as a shareholder.

We, or more pointedly, I was caught off-guard by these moves, as were other investors who had just bought shares from the major shareholder that sold out, and hence there was savage treatment handed out to the share price in December with the price down more than 40% since September. This took roughly 4% off fund performance for the quarter.

I have sold some of our holding to reduce our exposure to a business that appears to have run out of growth options with the industry now consolidated into two main players. And while we have done very well on our investment over the years my tardiness in acting on my doubts that the company's best years were behind it have cost us money in recent times. Billimoria had been at the helm of the company for nearly 20 years and as he outlined his plans to broaden the range of services to existing customers and continue to seek cost efficiencies, I believed there was sufficient reason to remain a shareholder with the shares reasonably priced. However, the jockey has now jumped off the horse and we should look to as well.

PWR Holdings
During the past quarter the company held its AGM where we had the opportunity to spend some time with Chief Engineer, Matthew Bryson, and inspect the new facility the company has leased to house its new Micro Matrix technology and the equipment the company has ordered for further expansion. Owner manager businesses feature highly in the portfolio and so I should mention that Matthew is also a major shareholder in the company in his own right and has been with PWR for more than 15 years, so he is experienced, motivated and his interests align with us as shareholders.

Coincidentally, on the same day as the AGM the changes to the F1 rules were announced and as the company had predicted they were left largely unchanged by the changes and should remain unaffected for the next few years now.

From a standing start just over 10 years ago PWR is now almost the only supplier to F1 racing for cooling systems and has become a world-class business. With the successful development of its Micro Matrix technology its intentions now are to become a supplier to the aerospace and military industries as well. PWR's previous major competitor in F1 used the same strategy successfully and now PWR is pursuing it too.

The company has continued to pick up contracts to supply cooling systems for niche, high-end production runs for performance cars and this will boost earnings in the short-term, but the real potential for the company appears to lie in the aerospace industry and to support this the company has recently appointed an industry expert to lead this endeavour.

MFF Capital
With USA markets up strongly, and in particular the company's major investments in Mastercard and Visa, MFF Capital has delivered another good performance with net assets up 36.3% for 2019 and 4.5% this quarter. Mastercard and Visa represent 32% of the company's assets, up from 26% a year ago and hence on a "look-through" basis 3.7% of the fund is invested in these two wonderful businesses.

Mastercard saw its earnings per share grow by more than 30% in the past year and Visa likewise saw earnings per share growth of more than 20%. Both have experienced strong rises in their share price over the past year assisting MFF to outperform the broader US market. Other large holdings such as Home Depot and Bank of America also rose strongly during 2019.

Chris Mackay, the portfolio manager, has done an excellent job managing the portfolio displaying both the temperament, as well as the skills, to capture market-beating returns. Recently, the share price has drifted toward the top end of its pre-tax asset backing and along with recent strong market performance it would be ambitious to think that the recent performance will be repeated in the short-term.

Nearmap
We attended the Nearmap AGM in November where attendees were provided with a demonstration of its Artificial Intelligence (AI) content offering as well as some guidance for the coming year. The demonstration of its AI content highlighted not only the commercial possibilities, but also the quantum of improvement in just a few months.

The price has languished in recent months but that belies the underlying developments within the business as it continues to expand in North America and Canada. At the AGM the company confirmed that Annualised Contract Value (ACV), which is a key metric to follow, will grow by more than 30% this year and that commercialisation of the AI content will begin in the second half of FY2020.

Nearmap is another world-class business within the portfolio and within the next two years it would not surprise us if its offshore revenue is greater than its Australian business as they continue to gather new clients and deepen their customer relationships through AI.

The Jockey Matters

Anyone who has watched the recent Netflix series, Inside Bill's Brain, about Bill Gates or was lucky enough to meet Warren Buffett early in his career would have realised both these men would be successful in whatever venture they undertook. In the case of Warren Buffett, worrying about the merits of a textile business in New England (Berkshire Hathaway) would have been a distraction rather than necessary.

Closer to home, and more recently, Jack Cowin, the man who brought KFC to Australia in the late 1960's, invested $400,000 for a 50% stake in Brisbane based Silvio's Dial-A-Pizza in 1986 with a young Don Meij working in the business. Silvio's became Domino's Pizza and Don Meij has now run the business for more than 20 years and turned Cowin's stake into a $1billion fortune. For the mathematically inclined that's nearly 30% per annum for 30 years and to Cowin's credit he has never sold a share.

We first met Meij in 2006 after Domino's had bought their first franchise area in Europe, and we thought he was the best CEO we had ever seen and would grow Domino's significantly. We were right and clearly the critical decision to be made was not the next 12 months earnings or whether the price was too expensive at current levels – it was assessing the future prospects of the business and the management running it. Our great error was selling our investment after several years when we assessed the price had got ahead of itself – a very painful lesson for us and unitholders.

Phil Fisher covers this type of thinking in a clever exercise in his seminal book, 'Common Stocks and Uncommon Profits'. Fisher asks the reader to imagine that you are a graduate of a university class and for 10 times the first year's earnings (maybe we should make it 20 times in the current environment), the reader can earn 20% of any fellow student's earnings for life. In such a situation the type of critical decision making will not centre around how popular the person is, how good-looking the person is, or perhaps even what their first year of earnings will be. Fisher then suggests that because it's a big class you should ignore the students you don't know well and concentrate upon those that you can make some form of assessment about. **Eventually you would pick the classmate you felt had the greatest earning power (my emphasis).**

Then suppose it's a 10-year reunion and the classmate you invested in has done incredibly well and earning a very attractive salary with a very attractive position and still likely to earn even more in the coming 10 years. What should you do?

It is here that market commentators who urge taking profits on stocks that have "gotten ahead of themselves" and "look expensive" might say that you should take some profits by selling your stake in your classmate's earnings and rotate into something less expensive. But Fisher points out that it is ridiculous to give up on a classmate that is performing well to replace them with part of the earnings of a classmate who is still earning not much more than when he left university ten years ago. He goes on to say, the argument that your successful classmate has had his advance while the success of your (financially) unsuccessful classmate lies ahead of him is rather silly.

It appears Jack Cowin learnt this lesson well and has reaped the rewards for it. The decision to sell Domino's when we had already read Phil Fisher's book is something I still have no explanation for.

Liquidity Testing

Each year we conduct a test of the liquidity of the portfolio. This is not something that we have shared in the past, and it's not something we overly focus upon either given our long-term investment timeframe, but nevertheless some unitholders may find it interesting.

The purpose of the liquidity test is to determine how much of the portfolio could be sold under various conditions. Using the trading volumes from July to September quarter and assuming various assumptions, we have assessed that 43% of the portfolio could be sold under extreme stress condition in just one day, while 100% of the portfolio could be sold in 30 days under low stress conditions. Again, this is not something we focus upon unduly, nor do we target liquidity levels per se, but it is something we are cognisant of at times, particularly around portfolio sizing.

Thank you for your ongoing support throughout 2019. For existing unitholders that would like to make additional investments the application form has been modified and it is a simple process of completing the last page of the application form which is available on our website or by contacting us directly.

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