Ganes Capital Management Ltd *ACN 102 319 675 AFSL 291 363*
Ganes Focused Value Fund *ARSN 117 119 712*
PO Box 3512 Newmarket Qld 4051
Phone: 1300 766 916 ● Fax 1300 766 917 ● admin@ganescapital.com.au ● www.ganescapital.com.au

GANES FOCUSED VALUE FUND – DECEMBER 2015

Unit Prices*

	31.12.15	30.06.15	30.06.14	30.06.13	30.06.12	30.06.11	30.06.10	30.06.09	30.06.08
Entry Price ($)	**$2.7729**	$2.5890	$2.5716	$2.4721	$2.0377	$2.0438	$1.8024	$1.5322	$1.8130
Unit Price ($)	**$2.7626**	**$2.5800**	**$2.5626**	**$2.4635**	**$2.0306**	**$2.0366**	**$1.7961**	**$1.5268**	**$1.8067**
Exit Price ($)	**$2.7529**	$2.5709	$2.5537	$2.4549	$2.0235	$2.0295	$1.7898	$1.5215	$1.8003
Distribution (cents per unit)	**2.5462**	**8.0993**	**4.0178**	**4.5014**	**4.8340**	**6.7378**	**5.8396**	**6.6702**	**11.6800**

* Unit prices are quoted pre-distribution. The *total* distribution paid during the financial year is shown.

Past Performance*

	Ganes Focused Value Fund	ASX300 Accumulation Index	Margin
3 months	9.2%	6.5%	+2.6%
6 months	9.2%	-0.4%	+9.5%
1 Year	10.0%	2.8%	+7.2%
2 Years (p.a. compound)	5.9%	4.0%	+1.9%
3 Years (p.a. compound)	9.3%	9.0%	+0.3%
5 Years (p.a. compound)	8.3%	6.7%	+1.6%
7 Years (p.a. compound)	13.5%	9.9%	+3.6%
10 Years (p.a. compound)	9.3%	5.5%	+3.7%
13 Years (p.a. compound)	12.6%	8.7%	+3.9%
Value of $10,000 invested at inception (14/10/2002)	**$45,598**	**$31,581**	

Largest Ten Holdings

Flight Centre (FLT)
Templeton Global Growth (TGG)
Isentia (ISD)
ARB Corporation (ARB)
Magellan Flagship Fund (MFF)
PM Capital Global Opportunities (PGF)
Reece Australia (REH)
Smartgroup (SIQ)
Beacon Lighting (BLX)
Austbrokers (AUB)

Portfolio Allocation

Top ten	47.3%
Other shares	46.4%
Cash	6.3%

* Fund performance is net of all fees and expenses, and assumes reinvestment of distributions. Investments can rise and fall in value. Past performance is not necessarily indicative of future performance. The fund currently invests substantially in smaller companies that may involve unique risks. The Product Disclosure Statement details the risks associated with an investment in the fund and is essential reading for investors.

After recording a lacklustre return of 5.3% in calendar year 2014, the local market has finished 2015 with another modest return of 2.8%. Overseas markets also took a breather during 2015 with the S&P500 (USA) providing an even more modest return of 1.5% for the year.

The Fund produced a 10.0% return in calendar year 2015, outperforming the broader market by 7.2%, with most of the outperformance being generated in the past six months when the market was flat. After a disappointing year in 2014 in which we suffered because of our high cash weighting and our larger holdings performing poorly, it was a return to the type of returns we traditionally expect to generate with our larger holdings performing well and generating the bulk of the Fund's returns.

The Fund hits the 13 year mark

The Fund celebrated its 13th anniversary in October, something we are quite proud of, and we would like to thank investors, many of whom have shown their support for more than a decade. Over the last ten years the broader Australian market has produced a return of 5.5% per annum, and the Small Ordinaries Index has produced an even more modest 1.4% per annum.

For investors in the companies that make up the Small Ordinaries Index, a 1.4% annual return would certainly constitute a lost decade. A $10,000 investment ten years ago is worth just $11,528 today. Investors in the All Ordinaries index, a benchmark dominated by large companies such as the big four banks, have fared much better with their $10,000 investment now worth $17,393. Over the same period, the Fund has produced a compound average annual return of 9.3% meaning investors in the Fund have more than doubled their original investment to $24,333 and a $10,000 investment in October 2002 is now worth $45,598.

Our investment approach of buying quality businesses at fair (but hopefully attractive) prices and holding for the long term to enjoy the benefits of the underlying business has provided return that would suggest the decade has been anything but lost, despite the GFC and not investing in the greatest resource boom the nation has seen.

Why we try to avoid resource companies

We avoided mining and energy companies during the resources boom, and missed out on some spectacular returns that were available during this period. It is always hard to watch others make "easy" money while maintaining a more conservative investment approach. But being dependent upon a cyclical commodity price which you can't control in an environment where supply always seems to eventually match (or exceed) demand just looks a poor business to be the owner of to us, despite the fact that Australia has been a major beneficiary of this sector.

Even though mining stocks had already been pummelled through 2014 as the resources slowdown firmly took hold, even we were surprised by the further declines in commodity prices in 2015. Iron Ore fell a further 36% during the year, oil was down nearly 20%, and coal more than 25%. An investor in BHP is now 28% worse off than this time last year, but even more shocking is that the 10 year return for an investor, during one of the biggest resources booms ever, is 0.4%. Yes, less than 1% per annum from one of Australia's largest companies with some of the best resource projects in the world. Shareholders in RIO have fared even worse with a negative return over the past decade.

Long ago we made the decision that we had no talent for predicting commodity prices. And as Venture capitalist Fred Wilson is quoted as saying: "The only way you win is by knowing what you're good at and what you're not good at, and sticking to what you're good at". Charlie Munger labels this as someone's circle of competence, and we are not afraid to say that resource companies fell outside our circle of competence then, and remain so now.

Portfolio review

Only six months ago we stated that we were finding better value on offer in the smaller company areas of the market and were feeling more confident than we had for some time. During the year we found a number of companies to add to the portfolio and as a result our cash weighting has reduced from 36% at the end of 2014 to just 6% at the end of December. In addition, most of our larger holdings had a good year and as we have written previously, they do most of the 'heavy lifting' in generating Fund returns.

The top ten holdings of the Fund represent nearly 50% of the portfolio and this has been typical since inception. Our investment philosophy has always been that there are only a finite number of good companies in Australia that we want to own and unitholders are better rewarded through investing in these companies rather than adding a wide array of others, of which we are usually not as confident, and thereby potentially diluting our overall returns.

We started the year with **Flight Centre** as our largest holding even after it had fallen 32% during 2014. Despite terrorist attacks, a falling Australian dollar and the ever increasing threat of online competitors, the company still had a reasonable year. Transaction volumes increased nearly 10% for the year, but profits were down 3% as margins were reduced to attract business. The share price rose 27% during the year and has provided a 10 year return of 19% per annum. After having owned the stock for nearly a decade and riding the ups and downs we took the decision in the last few months to reduce our exposure as the much talked about online competition appears to becoming a more real threat, and the stock had grown to more than 10% of Fund assets.

While Flight Centre performed well, the Fund enjoyed an even greater investment contribution from one of our new investments, **Smartgroup**. The salary packaging company floated in mid 2014, however, it wasn't until April 2015 that we purchased the bulk of our holding around $1.70 per share. Smartgroup is an incredibly profitable business with profit margins of more than 30% and return on Shareholders Funds of 26%. But it had a couple of very big minuses as a listed entity: the business relies on tax legislation for 90% of its revenue, and it was being sold by private equity.

These were large risks that we mulled over for quite some time. US Fund manager and columnist Ken Fisher likes to say that investors don't need to consider the risks that are being discussed by other investors and market commentators as these are already factored into the price – it's the risks not being considered by the market that cause problems for investors. We considered the regulation risk was in full view and had received a lot of media coverage after Kevin Rudd famously changed the rules for the industry without warning in July 2013 and the share price of McMillan Shakespeare fell more than 50% in one day.

Therefore we considered the share price reflected this risk and the shares represented good value. In addition, we also believed the market was not clearly understanding the profitability of the business because of the accounting treatment of amortisation which saw reported statutory profits much lower than what we considered the economic profit of the business to be. Since our purchase only eight months ago the share price has tripled, which we confess surprises us and was not even considered a possible outcome in our analysis. In the short term much of what we see in terms of investment results in the market is luck, although many Fund managers might try to convince investors otherwise, and this is one situation where we have had a firm tailwind behind us for the past few months but equally one where we believe the company can produce attractive returns through profit growth over the coming years.

The postscript to the McMillan Shakespeare story is that even though the share price fell heavily in July 2013 and has still never fully recovered it has still provided patient investors returns of 15% per annum over the past 5 years and 25% per annum over the past 10 years. Its profits and dividends have risen five-fold in the past decade and it is one of the better performing publicly listed companies.

The ARB Story
One of the earliest investment decisions in the life of the Fund in March 2003 was to buy shares in ARB Corporation, a little known 4WD parts supplier based in Melbourne with revenue of $120m, profits of $14m and a market capitalisation of $185m. At the time paying more than 13 times earnings for a small company was not considered a bargain, but the growth the company had produced since listing in the late 1980's and the potential growth we believed lay in front of the company meant we were happy that we were paying at least a fair price.

And as we have said before, our investment approach is to estimate the future performance of the business, and this is very different to predicting sharemarket price movements – we were not buying because we thought the price would go up 20%. We prefer to look at the underlying economics of the business and assess its merits for providing a good long term outcome for investors.

The nature of our investment approach is to hold our investments for the long term because eventually the share market performance should reflect the underlying performance of the business. We call these businesses compounding machines.

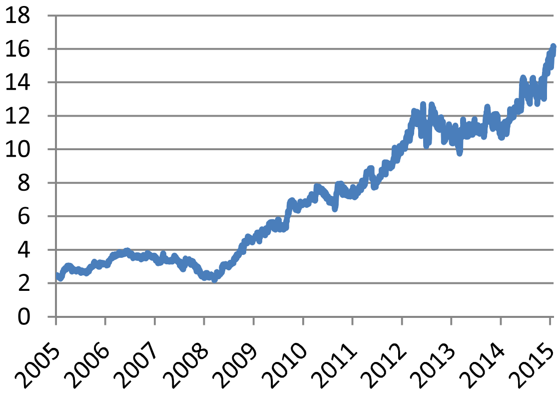
And what we are ideally trying to find are businesses that can produce high incremental returns by being able to employ additional capital at attractive rates of return. ARB has always ticked all these boxes and hence it has always been one of our larger holdings.

Investors are exposed to lots of information when investing in publicly listed companies, some of it is helpful, but most of it is usually someone else's opinion and should be read with some degree of skepticism, and more importantly, acted upon only when the information is meaningful.

During our more than decade long investment of ARB we have read headlines and research pieces about the banning of bullbars, surging steel prices, volatile currency movements, shortage of workers, Chinese import threats and car sales declining. Despite all these challenges the company has continued to grow profits solidly for more than 20 years. In the past decade the company has tripled profits while maintaining a very conservative balance sheet and continuing to develop new products.

By not worrying excessively over the short term volatility of the company's share price and displaying some patience, investors have been richly rewarded. The chart below shows just how well the company has performed over the past decade, in fact, this sit on your hands and let the company do the work is our perfect type of investment. It's not generally recognised but temperament can play a large role in generating investment returns in these types of situations.

ARB has provided shareholders with a 10 year return of 24.4% per annum, that is for every $10,000 invested in the company it is now worth nearly $90,000. These types of businesses are scarce and hence when we find them we usually make it a meaningful position in the portfolio. Following a 45% rise in the share price for the year it is highly likely that we won't see a great return in 2016, but we appreciate investment gains don't arrive in a smooth line every year, as much as we or you would like them to.



As we did last year at this time of the year it is opportune to reflect on what worked in the portfolio, what didn't work, and more importantly what lessons we learnt from this.

What didn't work:

1. Being too slow to sell when confronted with deteriorating circumstances. While the portfolio generally performed quite well during the year ,our willingness to hold companies for the long term also had some negative impact as well. The largest of these were Pacific Group, the former Treasury Group and Austbrokers. Similar to ARB and Flight Centre we have had an investment in Pacific Group for nearly ten years and understand that the Funds management business can be a very profitable business if well managed despite the inherent volatility of equity markets. In late 2014 the company made a large acquisition/merger with a US based Funds manager Northern Lights. While the deal made sense on paper, at the time we had our reservations, particularly as due diligence and client retention can be quite difficult in these types of deals. But following the announcement of a change of management, and deteriorating Funds under management we took the decision to sell a large part of our holding in April 2015. Unfortunately since then the company has announced the sale of one of its best performing asset managers and along with this the share price has fallen 35% during the year. We have fully exited the position but nevertheless it reduced Fund performance for the year.

Similarly Austbrokers has experienced deteriorating industry conditions that are unlikely to change for quite some time, along with a change of management. We have reduced our exposure here as well but this slowness to act to these two situations reduced Fund performance by approximately 2% for the year.

2. Dick Smith. As we write this end of year report Dick Smith has been placed in Voluntary Administration and shareholders are likely to lose all their investment. Our track record in specialty retailers has been quite good with the likes of Beacon Lighting, Nick Scali and in years gone by Fantastic Furniture. But along with a lot of other investors and analysts we got it wrong on this one. Fortunately we exited our small position but not before recording a significant loss on our investment and reducing Fund performance by 1% for the year. Inventory turnover and cash flow are critical in this industry and Dick Smith has reinforced the necessity to focus on this regardless of the apparent value and management assertions.

What worked:

1. Small companies came back into favour. There is no denying we had something of a tailwind in some areas of the portfolio this year as smaller companies outperformed larger companies. This is not something we can control but the Fund has benefitted from the market seizing on the potential profit growth that smaller companies can provide. As an example, a previous holding in the Fund, Domino's Pizza, increased five-fold during the year, and Smartgroup, as we mentioned earlier, rose nearly three-fold from our purchase price in less than a year. Rest assured their profits or intrinsic value have not risen at the same rate over the year.

2. Being far more fully invested. During 2013 and 2014 we had held very high levels of cash, as we simply weren't prepared to invest in companies that we didn't believe offered attractive returns at their current prices. During the year we have found a number of smaller companies that met our investment criteria and were added to the portfolio so that we were able to maintain a far more fully invested portfolio throughout the year.

3. Avoiding mining service companies. Our commitment to stick within our circle of competence continued to see us avoid many of the disasters within the resources and mining services industries. Despite the battered share prices and seemingly compelling value on offer in various places, we continue to believe we don't have the requisite skills to identify who will be the winners from the wreckage. As Charlie Munger has often said, "it's not how smart you are, it's knowing where the limits of your circle of competence lie". No doubt some astute investors, and perhaps some lucky ones too, will make a fortune in this sector but it won't include us. These companies were in our 'too hard' bin last year and with plenty of other opportunities available during the year, they remained there.

4. Seeing value overseas. We do not predict currency movements, as they are even harder to predict than share prices (which are impossible), but we did believe that the Australian dollar was overvalued, and had been for some time, and that exposure to international markets would benefit investors. This theme continued to play out again this year, but not as strongly as in previous years.

Our often-quoted example of this exposure is via Magellan Flagship Fund, a Listed Investment Company (LIC) that invests internationally without hedging its currency exposure. The share price was up a further 17% this year, and has now returned 26% per annum for the past five (5) years. This is an outsize return that we could not have predicted when we started buying the shares in late 2010.

We have made our returns from three components to the investment. First, when we started buying the shares they were selling at a discount to their net asset backing meaning we were able to buy shares in companies such as American Express, Wells Fargo and Visa cheaper indirectly than we could directly. That discount has now disappeared and in fact the shares usually sell at a premium to NTA most days so the narrowing of the discount provided some return. Second, the underlying performance of the portfolio of international companies has performed well and the NTA has risen, and lastly the Australian dollar has fallen against the US dollar providing further returns to the portfolio.

We have extended this investment thesis further this year with investments in Templeton Global Growth and PM Capital Global Opportunities which we were able to buy at discounts to their underlying asset value. These two companies also offer exposure to international markets but with different investment strategies to Magellan, and while they performed relatively poorly during the year we believe they should still offer an attractive return over the long term.

Generally speaking the portfolio performed well and decisions made over the past few years have borne fruit such that the Fund has outperformed the market over both the short and long term. Again we thank you for your support and we look forward to your continued support in 2016. A 2.54 cent per unit distribution has been paid for the first half of the year.