GANES
FOCUSED VALUE FUND

APIR GCM0001AU | ARSN 117 119 712

MARCH 2020 QUARTER REPORT

Portfolio Performance

In the latest quarter the unit price fell 25% to $2.47, and 15% over the past year. The fund has returned 5.9% per annum for the last 10 years and 9.5% per annum since inception.

Normally in the March update I would outline the recent progress and half year financial results of our major investments. However, the coronavirus pandemic has created unprecedented times meaning that predicting profits or using the latest results are largely meaningless as to how businesses are faring.

Many companies are abandoning their profit forecasts made just a few weeks ago. We have even seen companies like Flight Centre see their revenue, (not profits but revenue) head towards zero.

The coronavirus pandemic still has some time to play out and there remain multiple outcomes possible. Things could get worse, but it is impossible to pick absolute bottoms as much as it is to pick absolute tops. Markets will turn as the bad news diminishes.

As you will read in the update, I believe this has presented investors with the best value seen for more than a decade.

In this update I will address three issues that as investors I believe are important:

- How the fund has been impacted;
- What have I done within the portfolio as a result of the market fall; and
- Where do the opportunities lie?

Performance as at 31 March 2020:

	Fund (net of fees)	ASX 300 Accum. Index
3 months	-25.0%	-23.4%
1 year	-15.1%	-14.5%
3 years p.a.	0.7%	-0.6%
5 years p.a.	2.2%	1.4%
10 years p.a.	5.9%	4.8%
Since Inception (p.a.)*	9.5%	7.7%
Value $10,000 invested since inception	$48,561	$36,318

*Inception date of Fund is 14/10/2002

Unit Prices as at 31 March 2020:

Entry Price	$2.4798
Unit Price	$2.4736
Exit Price	$2.4675

Top 10 Holdings:

Company	Code	Weight (%)
PWR Holdings	PWH	12.7
MFF Capital	MFF	12.2
Reece Australia	REH	7.7
ARB Corporation	ARB	6.2
Domino's Pizza Enterprises	DMP	6.1
Cochlear	COH	5.5
CSL	CSL	5.5
Dicker Data	DDR	5.3
Nearmap	NEA	4.0
Lovisa	LOV	3.7

Top 5 Sector Exposure:

Sector	Weight (%)
Consumer Discretionary	33.4
Financials	21.5
Information Technology	15.4
Health Care	11.5
Industrials	9.6
Cash & Other	8.6

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There are decades where nothing happens, and there are weeks where decades happen.

Vladimir Lenin

You make most of your money in a bear market, you just don't realise it at the time.

Shelby Davis

How the fund has been impacted

Within the fund we have not been spared and the unit price has fallen in tandem with the market to this point. However, I believe the long-term value of our investments remain intact so we can ignore these prices if we choose to – as you might ignore your neighbour who makes unrealistic offers on your house. However, there is no doubt that some businesses are now worth less, and in some cases a lot less, than prior to this pandemic which I shall cover shortly.

Within the fund the best performers were CSL and Domino's Pizza which were flat for the quarter, while we have seen some companies such as Lovisa and Nearmap that have had significant falls which appear to be partly the result of distressed or forced sellers, as well as the changed economic conditions. There may have also been concerns that both of these companies would need to raise capital which may have spooked investors, but both have since released statements which indicate they won't need to.

In these types of markets forced sellers at distressed prices are not a good guide to the underlying value of a business – rather they provide opportunities for knowledgeable buyers with cash.

Because of the impacts on travel, consumer demand and the shutdown rules, businesses have needed to deploy a number of strategies to survive which do have an impact on business values. In the first instance these measures have included:

- cancelling or delaying dividends;
- drawing down credit facilities or taking out new loans;
- standing down staff and closing shops or requiring staff and directors to take lower wages (typically 20%);
- or in the worst case, raising new capital from shareholders at discounted prices.

Cancelling or delaying dividends doesn't directly impact the value of the business but it does mean that shareholders will see less return on their investment this year. We have had a number of companies that have taken this option including ARB Corporation, Lovisa and AUB Group.

A number of companies have also announced they will draw down credit facilities or increase their borrowing limits to provide liquidity should they need it. To use a real estate analogy, the equity in a house with a mortgage is worth less than the equity of a mortgage-free house and so this will have some impact on the value of our companies. Nearly all the businesses we own within the portfolio are debt-free and have credit facilities available to them so they should be able to borrow on normal commercial terms. Our largest holding, PWR Holdings, has indicated it has drawn down a credit facility that it had available and Lovisa has stated it will increase its credit facilities with the expectation it may need to use them.

A number of companies, mostly in the retail sector, have been forced to shut shops or stand down staff. PWR has announced that staff are working a 4-day week due to cancellation of Formula 1 races, while Domino's Pizza was forced to shut shops in parts of Europe (mostly France) and Lovisa has closed its network of stores both here and overseas as well. These measures will affect profitability for this year, however as we have seen in China and Singapore it may not have a lasting impact on customer demand once stores re-open.

Finally, some companies have been forced to raise capital, sometimes at prices which have permanently diluted value for existing shareholders, and it is almost certain we will see more of this before the crisis has passed. We saw this occur during the GFC and so we have always tried to invest in companies that don't require additional capital to grow, and with managers that recognise the value it destroys for existing shareholders when they do.

Apart from Cochlear and Reece most companies in the portfolio have indicated they won't be raising capital. Owning profitable businesses with managers that harbour their capital wisely is an asset as it allows us to deploy our capital into other opportunities. We have seen shareholders of companies like Kathmandu and Webjet not fare so well and this is likely to be the area where most permanent capital will be destroyed for investors over the next few months.

What I have done

I have not made any major changes to the portfolio, but I have taken steps to reduce our exposure to specialty retailers and any company with higher debt levels than I think prudent in this environment. To this end our small holdings in Nick Scali and Beacon Lighting have been sold and I reduced the weighting in Reece due to its higher debt levels from an acquisition it made 18 months ago.

I am confident that the long-term prospects for our major investments remain intact, they may even be enhanced as a result of the pandemic in some cases, hence, I have not sold any of these positions. To do so would deliver a certain tax bill for unitholders and adds the unknowable possibility of re-purchasing later at prices low enough to sufficiently account for the tax payable. Creating a tax bill for investors to "buy" cash yielding less than 2% for the comfort of not seeing lower prices seems a high price to pay at this point if we are not forced sellers.

On the positive side, companies that I have previously thought too expensive have come back into view as prices fall to levels not seen for a decade. Companies such as ARB are selling at prices (and value) unseen since the GFC. For example, I have bought an asset at prices not seen for 20 years offering a very attractive yield of more than 13% on an historic basis which I will outline further in a future update. Panic or forced selling creates these types of events and requires being opportunistic rather than waiting to "see how this turns out".

In summary, the investment strategy remains unchanged, but our opportunity set has increased significantly. I am using that scenario to improve the quality of the portfolio.

Specifically, I continue to look for companies with free cashflow, little or no debt, good profit margins, the ability to grow without the need for external capital and with competent owner-oriented managers with significant skin in the game. These companies are rare and almost always expensive, and it takes uncertain environments like today to have the opportunity to become a shareholder.

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You don't buy company's based on today's headlines
Warren Buffett recently made this comment during an interview when he was being asked about current economic conditions. It's an important point. He went on to say that buying stocks in the Great Depression when production capacity and demand were at their lowest was the ideal time to buy, not years later when everyone was cheerful and positive again.

The patience to take a long-term view when everyone else is focused on the short-term is important right now.

Where the opportunities are
Distressed sellers. Whether it has been margin loan calls, investors requiring liquidity, or just a desire to get out of the sharemarket we have seen companies already experience price falls of more than 50% and sometimes at prices that indicate time was of the essence. This may have been the first wave removing the weakest hands at the table and more sustained selling could occur again later. It's hard to know, but when it occurs we want to be there as buyers.

Doing obvious things. With prices falling so quickly and the economic forecast so dire, many companies that have very long track records under various economic conditions are offering their best value in a decade. These are often relatively simple, easy to understand, good quality businesses. In this environment there is little need to search for arcane, difficult to understand businesses with high execution risk and multiple outcomes. Doing simple, obvious things is probably going to be rewarded just as well with lower risk over the next few years.

Not trying to predict the bottom. Trying to predict the bottom to buy a company is a fool's errand and not all companies will be at their lowest price at the same time anyway. If I can buy a business for 50c in the dollar today, waiting to see if I can buy it at 40c in the dollar tomorrow won't affect the investment results too much in a few years' time. The opportunity cost of missing out altogether by waiting for a price that never arrived won't show up in our investment returns, but as errors of omission they will be real all the same.

Companies raising capital at distressed prices. We have already seen companies such as Flight Centre, Kathmandu and Webjet need to raise capital urgently and at very distressed prices which has provided opportunities for investors with the capital to inject into these businesses to do so at attractive prices. We saw similar opportunities during the GFC, particularly in over-leveraged property trusts, and no doubt will see a lot more of this activity over the coming weeks and months. We may take advantage of this on a selective basis over the coming months.

Industries being shunned. With the closure of shops and demands by retailers for rent reductions or rent holidays, many property trusts have seen their prices fall by more than 50% along with the shares of the retailers that occupy their centres. In some cases this may be justified but when everything is being thrown out there Is no doubt going to be some value on offer in some circumstances. Equally, anything to do with tourism and travel has been decimated and there may be some value on offer there as well – although it remains in the too hard basket for the moment.

Shelby Davis

In these uncertain times I will leave you with the brief story of Shelby Davis, a largely unknown investor I admire, who created a $900 million fortune from patient long-term investing through many market crises. His favourite expression regarding buying in bear markets is at the top of page 2 of this update.

Born in 1909, Shelby Davis had a well-paid government job examining insurance companies when he decided in 1947, at the age of 38, he would quit and become a full-time investor. Starting with a borrowed $50,000 he started investing largely in insurance companies and financial services businesses. By 1969, at the age of 60 he had turned his original $50,000 stake into $50 million dollars – a remarkable achievement. Then in 1974, when he was 65, the oil crisis hit, banks failed, unemployment rose to 9% and shares fell precipitously seeing Davis's fortune reduced by 60% in less than a year.

Seeing the bulk of his fortune disappear it would have been understandable to move to cash while the oil crisis passed. But he stayed the course and by the time of his death in 1994, despite another severe recession in the 1980's, he had amassed a fortune of $900 million which he donated to charity.

Davis rarely ever sold his investments accepting the ups and downs of the market. In fact, many of his largest investments were held for his entire life, highlighting the benefits of compounding interest and investing in good quality companies. If you are interested in reading more, Shelby Davis's life is chronicled in ***The Davis Dynasty*** by John Rothchild.

Optimism never sounds as smart as pessimism, but it has always been the way to bet

Given that the physical infrastructure such as airports, roads and buildings have not been damaged as a result of the coronavirus pandemic, and the world has not lost its most productive members of society as it does during a war, I am confident that this too shall pass. With patience and a cool head, I believe this presents the best opportunity for investors for the past decade. In fact, for the first time in years I have more ideas for buying companies than money to do it with. As such I have added to my investment in the fund in recent weeks and if you would like to as well, I am happy to discuss this with you.