GANES

FOCUSED VALUE FUND

APIR GCM0001AU | ARSN 117 119 712

SEPTEMBER 2019 QUARTER REPORT

Portfolio Performance

The fund has enjoyed a very strong quarter with the unit price gaining 7.5% to $3.46. The fund has delivered a return of 8.7% for the past year and 11.8% per annum since inception.

The highlights for the quarter were the continuing strong run of Dicker Data following a good profit result and the sale of its property at Kurnell. PWH produced a strong result and Smartgroup bounced back after a reasonable result in tough conditions.

Changes to the portfolio for the quarter included some additional purchase of Domino's Pizza which brings it back into the top 10 holdings again after many years absence, and we also added to our Nearmap investment as its price fell following the profit results announced in August.

A new layout

Regular readers will note the different layout of the fund update. In trying to tell you how the fund is performing, and so you may better understand what it is that you have invested in, I am now sharing portfolio weightings as well as sector exposure with unitholders.

Classifying companies can sometimes be quite simple such as Cochlear within Healthcare but sometimes the sector description can also cover a wide range of territory. For example, PWR Holdings is included in Consumer Discretionary when very little, if any, of their business comes directly from consumers. However, the sector exposure does give you a flavour of where the portfolio is invested in broad terms. Our holdings in PWR and ARB make up nearly half of the Consumer Discretionary weighting, our largest exposure.

Cash currently sits at 9% of the fund.

Performance as at 30 September 2019:

	Fund (net of fees)	ASX 300 Accum. Index
1 month	4.1%	1.9%
3 months	7.5%	2.6%
1 year	8.7%	12.6%
3 years p.a.	11.4%	11.9%
5 years p.a.	10.3%	9.5%
10 years p.a.	10.3%	8.0%
Since Inception (p.a.)*	11.8%	9.4%
Value $10,000 invested since inception	$66,898	$47,083

*Inception date of Fund is 14/10/2002

Unit Prices as at 30 September

Entry Price	$3.4761
Unit Price	$3.4640
Exit Price	$3.4519

Top 10 Holdings:

Company	Code	Weight (%)
PWR Holdings	PWH	11.9
MFF Capital	MFF	9.4
Smartgroup	SIQ	9.3
Reece Australia	REH	9.3
ARB Corporation	ARB	5.7
Nearmap	NEA	5.6
Dicker Data	DDR	5.1
Gentrack	GTK	4.7
Cochlear	COH	4.6
Domino's Pizza Enterprises	DMP	3.5

Sector Exposure:

Sector	Weight (%)
Consumer Discretionary	32.8
Industrials	18.6
Information Technology	17.8
Financials	16.7
Health Care	5.4
Cash	8.7

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Profit Reporting Season

The last quarter was focussed on profit reporting season which took up all of August and most companies in the portfolio turned in good, and in some cases very good results.

PWR Holdings

PWR produced a standout result with profits growing strongly and the share price has recently hit new highs as the market begins to recognise the quality of the business and its growth prospects. Rather than focus on the positives which I have written about ad nauseum in previous updates, there are two issues that I am contemplating with our investment.

Firstly, October 31 will be taken up with headlines about Brexit but just as importantly for the fund, the Formula 1 governing body, FIA, will be announcing some rule changes that day with the aim of standardising some parts on the cars and reducing overall costs for the teams. FIA boss, Ross Brawn, has hinted that things like fire extinguishers, pit gear and even fuel pumps could be standardised. There has been no mention that cooling systems will be included but if they are there is no doubt that PWR will take a hit to its bottom line. How much is hard to say, and the company is stating that it's confident that cooling systems will be excluded from the rule changes. These sorts of scares have been around F1 for many years and reminds me somewhat of the intermittent scares about banning bullbars with ARB last decade (which never came to anything). But the price has risen strongly, it's our largest investment, and these changes could have an impact on the business, so I am not complacent about them.

And secondly, there has been some further Director selling in recent times. MD, Kees Weel owns most of his shares jointly with his son so it's hard to tell whether it's Kees, his son Paul, or a combination of both that are selling, but the reality is that after recent profit results they have taken the opportunity to reduce their holding. And in recent months Non-Exec Director Roland Dane also sold all his shares except for those held by his Superannuation fund. That's not a development I like to see. The AGM will be held at the factory later this month and Kees will be presenting at an investment conference in mid-October that we will be attending and no doubt he will be quizzed at these events as it will be top of mind for other investors as well.

Smartgroup

Smartgroup was a major contributor to fund performance for the quarter but mainly because of what it didn't do. With slowing sales in the car market and the company's increasing reliance on car leasing the market appeared to have factored in a poor result but the company delivered a modest increase in revenues and profits, highlighting the good management steering this business.

It appears the best acquisitions within the sector have dried up so the focus now is on expanding more services to existing clients and rationalising and streamlining the costs within the business. The heady days of the growth of the past few years may be behind it now but the company should be able to continue to deliver attractive returns for shareholders.

Dicker Data

The share price of Dicker Data has been on a tear this year which has contributed strongly to fund performance in recent times. The shares have risen 45% since June and 22% alone in September. Dicker Data was one of the best results reported in the fund with revenues up 19% and profits up 50%.

MFF Capital

MFF Capital has delivered another good performance with underlying NTA up 16.7% for the 2019 financial year and a further 7.1% in this quarter. However, our investment is not just a case of owning a Listed Investment Company selling at a discount that appeals. By having more than 30% of the fund in Mastercard and Visa, on a look-through basis, we effectively have 3% of our fund invested in these two wonderful businesses.

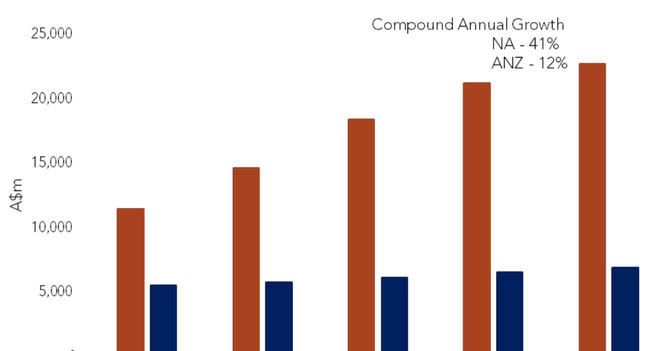
Nearmap

Nearmap was the largest detractor on fund performance for the quarter with the price down 33% since June. We added to our position after its profit results were released. While its revenue grew 45% and the company has gained good traction in its nascent USA business, costs were higher than expected and the market didn't like it.

Accounting principles don't always neatly explain economic value in a business and in the case of Nearmap it can be seen quite clearly. By opening a new sales office in the USA, the company has added to its cost base and reduced profitability over the short term. But when sales staff are adding at least $1 of revenue for every $1 of expense and profit margins are high then this is the right thing to do. I call this 'investing in the P&L'.

The easiest way for Nearmap, or any other growth company, to generate higher profits is to slow down spending on growth that must be immediately expensed. Of course, there is a big distinction between "investing" and wasting money unnecessarily and we rely on management to know the difference. We have other companies in the portfolio that fall into the same boat. Whether its store rollouts by retailers, adding engineers at PWR, or R&D spend by Cochlear for examples it's clear that increasing economic value is not always reflected by accounting results.

Nearmap is gaining new clients, they are spending more each year (average revenue per subscription increased by 23% for the year shown in the chart below), and they are staying longer (indicated by the churn rate falling to 5.3%), leading to very strong growth in revenue. And the sales staff are doing a good job with the Sales Team Contribution Ratio nearly three times higher than usual SaaS business model indicators. If they can continue to do that our investment should work out well.



	30 Jun 17	31 Dec 17	30 Jun 18	31 Dec 18	30 Jun 19
NA	11,443	14,648	18,404	21,217	22,698
ANZ	5,540	5,799	6,167	6,555	6,913
Group	5,996	6,597	7,473	8,410	9,208
YoY	18%	20%	25%	27%	23%

Why it's so hard to beat the index

The last 12 months have proven very difficult for active fund managers like ourselves to outperform, or even match, the broader market. This is common from time to time but why is that? With a ton of specialist knowledge and experience, and the ability to pick and choose what to buy and sell, why do fund managers as a whole underperform the market? I think there are four main factors and various fund managers, including this one, fall prey to each of them to varying degrees.

Letting Winners Run

The index has no qualms about the price of any particular company in the index climbing beyond anything that looks reasonable. It just patiently holds with no thought as to what price, or when, the company should be sold. However, investors almost always have some price whether its economic or emotionally driven as to when they will sell. They may also be driven to sell because the company has become too highly weighted within the portfolio. Again, this is a decision that an index is not forced to make.

The index is not trying to predict

Alongside letting winners run I think this is perhaps the biggest reason for the difference in returns between active and passive investors. Investors love narratives and the media is full of (mostly) fear and rumours because that garners more readers, which then leads to investors acting, or reacting, to announcements whether they be company specific news or more general pieces such as opinions and forecasts on politics or economic activity. By contrast the index just holds and doesn't try and predict. Temperament is a greatly underrated skill in investing when everyone has access to data and a spreadsheet.

Low Activity

With changes made to the index only a few times a year they have very low turnover and therefore very few costs. By contrast most active investors have much higher trading costs such as brokerage but also hidden costs such as buy/sell spreads. In themselves these costs are not much individually these days but if an investor is frenetic in their activity they will soon add up.

It is very rare that a fund manager writes or says "I was perfectly happy with the portfolio so we did nothing this quarter". The ability to sit quietly is another very underrated skill in investing and we should never confuse activity with progress.

Let losers go – don't double down

As prices falls a lot of investors tend to think that if it was good value at their original purchase price then it's even better value now and buy even more. Indexes let stocks sink without attaching any emotion or rationalising the price movement.

Lovisa – a new addition to the portfolio

Lovisa was a new addition to the portfolio during the quarter**.** For investors with teenage daughters this company needs little introduction, but for the rest of us Lovisa is a retailer that sells fast fashion accessory items at very affordable prices.

From its original beginning with a shop at Chermside in 2010, Lovisa has now grown to have 390 stores in 11 countries and sales of $250 million. Overseas stores now comprise more than 60% of the business and the company has just started its rollout in the USA where the early signs indicate it could be a big success. The company now has 21 stores in the USA, mostly on the West Coast, but it will eventually have multiples of this as it builds out its store network. The USA market is a significant opportunity for the business although costs could be higher, and therefore margins lower than in Australia.

What has attracted us to the business are its big profit margins. With a gross profit margin of 80% Lovisa is no ordinary retailer. To put that number into context, it is higher than Inditex, the owner of Zara, considered one of the best retail businesses in the world. To buy something for $1 and sell it for $5 suggests this is more than a transaction of goods, the business is adding value to its customers in other ways.

An investment case is not built around personal anecdotes but this concept of adding value was highlighted to me by two stories I heard while researching the business. One was a friend with two young daughters on an outing, and rather than buy them a meal at a fast food outlet he took his daughters to Lovisa where they spent the same amount of money but received something far more tangible and longer lasting than a meal that is soon forgotten. For both Dad and the daughters this was a win-win. The other is that of a daughter of a friend entering the workforce and her daughter regularly buys pieces of jewellery, as often as weekly, that she finds very affordable and can wear to work and keep her wardrobe updated. It's this type of customer that provides the business with the ability to turn over their inventory at much higher levels than other fashion retailers.

From an operational perspective the stores have a small footprint, don't cost a lot to fitout, and appear to have sales per square metre that easily exceed that of other fashion retailers.

Execution of its overseas rollout is the obvious risk for investors as well as managing their supply chain as they become a truly global business, but the founder CEO, Shane Fallscher, and Chairman and Rich Lister, Brett Blundy have successfully grown the business thus far and both have big stakes in the business and are closely aligned to its success.

Retailing is a hard business to build any competitive advantage and more often than not investors can come out behind, so I am very mindful of this when sizing our position.

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