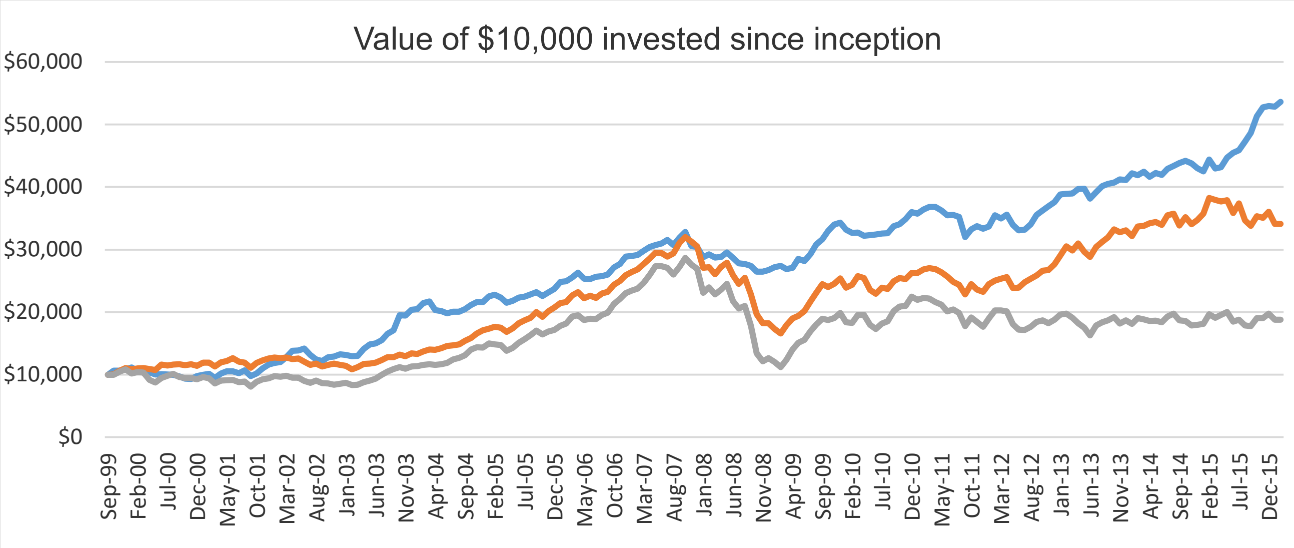
**<u>The Supervised Fund (TSF)</u> – February 2016 monthly report**

Dear unitholders,

The fund's performance compared with the All Ords Accumulation Index is set out as follows.

| | TSF AFTER ALL FEES | ALL ORDS ACCUM | TSF OUTPERFORMANCE |
|---|---|---|---|
| Month ending 29 Feb 2016 | 1.38% | -1.47% | 2.85% |
| 6 Months | 13.39% | -8.82% | 22.21% |
| 1 year | 20.69% | -12.23% | 32.93% |
| 3 years (p.a) | 11.24% | 3.23% | 8.01% |
| Since inception (p.a) (16 years) | 10.77% | 7.80% | 2.97% |




In the above chart the blue line represents an investment in TSF (after all fees), the grey line represents the Small Ords Accumulation Index and the orange line represents the All Ords Accumulation Index. Please note the TSF returns include the previous USD denominated Supervised Investments Limited which merged with TSF in 2009.

As at 29 February the portfolio was composed as follows[1]:

| Largest Positions | % of NAV |
|---|---|
| Kangaroo Island Plantation Timbers Limited | 27% |
| Cash | 15% |
| HGL Limited | 10% |
| Australian Vintage Limited | 9% |
| Gale Pacific Limited | 6% |
| Samuel Terry Absolute Return Fund | 5% |
| Bell Financial Group Limited | 5% |
| Hunter Hall International Limited | 4% |
| BHP Billiton Limited | 3% |
| Sirtex Medical Limited | 3% |
| APN News and Media Limited | 3% |
| Co-Operative Bank PLC (unlisted) | 2% |
| South32 Limited | 2% |
| Molopo Energy Limited | 1% |
| Other net of fund liabilities | 5% |

- No capital is invested in options over indices or currencies. There is no futures exposure.
- 5% of capital is invested in non-ASX listed investments.
- 9% of capital is invested in ASX200 members.
- 6% of capital is invested in oil, gas and resources (ex gold).
- 82% of capital (excluding cash) is invested in companies with a market capitalisation of less than $150m.

[1] Please note we treat our investment in the Samuel Terry Absolute Return Fund as an allocation to non-ASX200 Australian equities.

## HOLDINGS COMMENTARY

February is a busy time of year during which many Australian companies report half year financial results. We spent the month trolling through current and potential investee companies' accounts as well as meeting with numerous management teams. It is always useful to participate in as many company meetings or conference calls as possible in order to gauge market sentiment.

We did not add any new positions to the portfolio in February.

**APN: 3% weight, up 16% during February**

Last month we reported a new 2% weighting in APN (click here to read last month's report). During February APN released financial results which met our expectations. We immediately bought more shares on this confirmation lifting our investment to 3% of unitholder capital. In the earnings release, management stated they will pursue a divestment of the Australian regional print media assets. The market took this as good news and the stock rallied in subsequent days. These print assets generate good cash-flow but are in secular decline; APN has been penalised for owning them as investors are unwilling to place a fair earnings multiple on other assets in attractive operating environments. While we are not expecting a hefty sale price, the divestment would allow APN to repay debt more quickly. This in conjunction with an improving earnings growth profile could expedite any re-rating of the stock. The divestment also simplifies the take-over transaction which we expect to come if and when the federal government amends outdated media reach laws.

**BHP & S32: Combined 6% weight. BHP up 1%, S32 up 28% during February**

These two positions were also added in January. Both have continued to do well into March as commodity prices have rebounded from multi year lows. South 32 was more leveraged to a commodity price rebound and reported a profit in tough conditions. BHP and S32 have balance sheets and operating assets which we think are sufficient to ensure shareholders will not be diluted if commodity prices remain near present prices for an extended period of time. From our assessment, both companies are close to fair value (perhaps a little overvalued) if commodity prices do not rebound but are extremely cheap if commodities recover over the next 2-5 years. We think the risk to reward is asymmetric and are comfortable with our exposure.

**AVG: 10% weight, up 20% during February**

Australia's second largest listed wine company reported a solid half year profit and excellent half year cash-flow. Management's commentary was more transparent than it has been in the past, although we think the full year guidance for profits to be up 10-15% is conservative. The stock rallied (and has continued to do so) as investor concerns around debt and earnings growth were mitigated. At current prices, AVG trades on about 14x 2016 earnings which is not inherently exciting. However, the company's cost of producing wine is about to decline by more than $10m per year as historical onerous grape supply and vineyard lease contracts come to an end. These savings alone will double AVG's annual profit. While this profit impact will take 2-3 years, the cash-flow benefit will be seen next year – we tend to prioritise cash-flow.

AVG operates in a challenging and sometimes unpredictable industry, but has a management team with a proven ability to succeed under tough conditions as well as macro-economic tail winds in the form of a lower AUD in their favour. As always, it was promising to see meaningful management and director share purchases on the back of the results.

**GAP: 6.5% weight, down 4% during February**

Gale Pacific manufactures outdoor knitted polymer fabric products which are sold to retailers and commercial clients both locally and internationally. During February the company reported a stellar result from both an earnings and cash-flow perspective. We expect profits to be up more than 25% in 2016 as the fruits of the highly competent and conservative new management team are born by shareholders.

The stock is up more than 75% over the last 6 months yet it is still cheap. It trades on 8x 2016 earnings which we think will grow at more than 10% into 2017 and has minimal debt. We think the management team can squeeze more efficiency gains over the coming years and expect they will revive the Australian commercial business. With about 35% of sales going to the powerful Bunnings Warehouse it will be good to see the company diversify into the higher margin Australian commercial and lowly penetrated US markets over the coming years.

**HHL: 4% weight, up 9% during February**

Hunter Hall International is an investment management company with near $1bln of funds under management (FUM). Of this $1bln, about 35% is 'locked up' in a listed investment company with the remainder in unit trusts. Because they are a competitor of ours we understand the key drivers of their business well. FUM has been declining over the past few years but seems to be stabilising as the returns have improved recently. Operating profit margins are in our view depressed because the existence of a negative performance fee accrual has forced management to pay fund manager performance bonus from management fees.

The current stock price is near $3; $1 of this can be attributed to cash and investments in their own funds. The funds management business presently generates18c of earnings per annum from management fees which is all paid out, meaning the remaining $2 per share trades on a 9% fully franked yield. If the investment team can continue to perform well FUM could grow and the company could recoup negative performance fee accruals (this will require about 12% outperformance). Such would materially improve the operating profit.

Recently the CEO has left and been replaced by the founder and Chief Investment Officer, the stock rallied on the news. While this could negatively impact the all-powerful fund rating agencies opinion and catalyse fund out-flows we think a lot of the retail investors who follow these agencies have already exited. Furthermore we expect cost reductions to more than offset any FUM reductions. We are already up more than 45% on our investment in Hunter Hall but think there is more to come.

**OUTLOOK**

We continue to look for investment opportunities and are looking forward to reporting on new allocations in the coming months. The fund is open to new investors and we welcome any queries on the portfolio, investment strategy and outlook.

Mitch Taylor and David Constable – 15 March 2016.

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