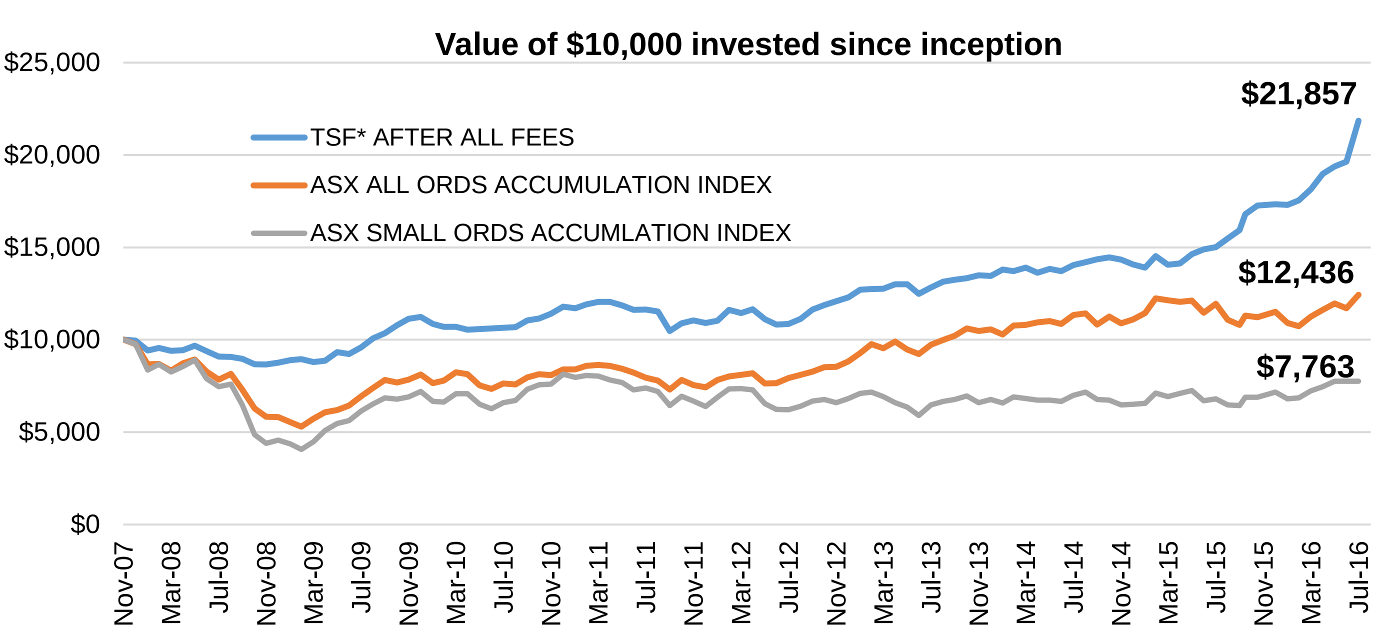
The Supervised Fund (TSF)

Monthly Report – July 2016

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 31 July 2016	11.26%	6.29%	4.97%
6 Months	26.29%	14.08%	12.22%
1 year	45.51%	4.02%	41.49%
3 years p.a	19.43%	8.52%	10.91%
Since inception p.a (since 1 Dec 2007)	9.54%	2.57%	6.97%



At 31 July the portfolio was composed as follows[1]

Top 15 Positions	% of NAV
Kangaroo Island Plantation Timbers Ltd	31%
Cash	4%
HGL Limited	9%
Gale Pacific Limited	7%
Australian Vintage Limited	6%
Bell Financial Group Limited	6%
Samuel Terry Absolute Return Fund	5%
Hunter Hall International Limited	4%
Po Valley Energy Limited	3%
Sirtex Medical Limited	3%
Base Resources Limited	2%
APN News and Media Limited	2%
BHP Billiton Limited	2%
Beadell Resources Limited	2%
IMF Bentham Limited	2%

- 1% of capital is invested in (put) options over stock market indices.
- 3% of capital is invested in non-ASX listed investments (excluding cash).
- 6% of capital is invested in ASX200 members.
- 10% of capital is invested in oil, gas and resources companies (excluding gold).
- 8% of capital is invested in gold mining companies.
- 77% of capital 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 equities.

*Please also note, prior monthly performance reports have quoted performance since inception including a previous UK vehicle (SIL) which operated from 1999 and merged with TSF in 2009. Given it is the start of a new financial year, we decided now is an opportune moment to begin quoting performance of only TSF. SIL also significantly outperformed stock market indices. Please contact us if you would like further information on original SIL returns.

Commentary

During July financial market participants seemingly shrugged off the previous 'Brexit' panic as global stock and bond markets both rallied.

Approximately half of TSF's monthly return was driven by our largest holding, Kangaroo Island Plantation Timbers Limited (KPT). KPT rose 25%[2] on the back of a company announcement detailing continued progress on a wharf development. Po Valley Energy Limited (PVE) rallied over 200% during July and contributed approximately 1.5% to the monthly return. PVE still trades at a significant discount to its break-up value which the Board has seemingly resolved to realise over the medium term (click here to read our recent summary of PVE's prospects). Other significant contributors to the monthly result included Hunter Hall International Limited (up 17%), Sirtex Medical Limited (up 23%) and our four gold mining stocks. The biggest detractor from July's return was our position in Co-Operative Bank PLC common equity, which fell 35% most likely because of increasing uncertainty regarding the 'challenger banks' asset quality in a post 'Brexit' UK.

Osprey Medical Inc. (OSP)

During the month we invested 2% of unitholder capital in OSP, an ASX listed medical device company. OSP's DyeVert device is designed to reduce the amount of contrast iodine (x-ray dye) injected into patients undergoing common heart and peripheral vascular procedures such as angioplasty and stenting. The amount of dye used during these procedures increases a patient's risk of dye related kidney damage known as Contrast Induced Acute Kidney Injury (CIN). The dye can generally be tolerated in patients with normal kidney function, however patients with poor functioning kidneys or those who have previously suffered a heart attack are at significant risk of CIN. Independent analysis suggests these at-risk patients represent ~25% of all patients undergoing the relevant operations in the US and EU. This equates to an annual revenue opportunity of approximately $1.5bln for OSP. CIN can have dire outcomes, including death for patients, and significantly erodes the profit margins of hospitals due to longer patient stays.

DyeVert has been approved for use in the US by the FDA and is essentially the only approved product in its category. A 2015 clinical trial illustrated a statistically significant dye reduction without jeopardising image quality. However, this same trail failed to prove a statistically significant reduction in CIN events and the stock subsequently sold off by more than 50%. It is not inherently unusual for a treatment to fail a clinical trial and subsequently be approved and adopted by the medical community. Thought leading clinicians tend to look beyond the headline and analyse the data themselves. Upon consultation with independent parties (who thoroughly understand the trial) and kidney specialists we concluded the reason the device failed to show a statistically significant reduction in CIN was due to poor trial design. It is well established within the medical community that a meaningful reduction in the quantity of contrast dye reflux will reduce the rate of CIN for at-risk patients (perhaps because the name of the disorder has 'contrast induced' in it).

It seems the US medical community may agree with our interpretation of the data. OSP has been piloting the device in a single Texan city, San Antonio, with a single salesman for the past 18 months. Today 65% of San Antonio hospitals have adopted the treatment. US hospitals have a financial incentive to adopt the device for at-risk patients - the device costs them an additional $350 per procedure and significantly reduces the risk of losing thousands of dollars from longer stay patients. This is particularly significant given the single digit profit margins large hospitals operate on.

[2] For the July 2016 valuation we valued KPT at the closing bid price of $20 rather than the last sale price of $24. The Volume Weighted Average Price for all trades during the month was approximately $18.50. It is our usual practice to value listed holdings at the last sale price, in this case we were not certain of "fairest" price. Accordingly, we asked our fund administrator to value the holding at the more conservative bid value.

Furthermore *The Patient Protection & Affordable Care Act 2010* (ObamaCare) has changed the economic landscape for US hospitals, redefining their structures towards quality metrics. Economic penalties now apply if hospitals do not comply with minimum overall quality. Dye volume is a key quality metric under ObamaCare – this may further incentivise hospitals to buy OSP's device.

The company has expanded its sales team to 15 staff with a further 5 expected to be employed by year end. These established executives have been tasked with emulating the successful San Antonio pilot strategy in 19 new similar sized US cities. The company is targeting cities with the highest incidence of at-risk patients. Our research suggests a comparable average salesman would be expected to sell units equivalent to USD1.5m in sales per annum (in OSP product terms) 24 months after entering a new territory or risk losing employment. OSP's success in San Antonio and the lack of available alternatives leads us to believe there is a good chance these salesmen will succeed.

OSP's market cap is currently ~USD60m (no debt and ~USD20m cash) which is significantly less than what the company spent in advancing the device to the present state. The company earns a gross margin above 70% but is yet to generate sufficient sales to cover overheads. Based on a conservative estimate of the success of OSP's sales reps we believe earnings will increase to USD25m within 5 years, this would represent a 10% market penetration. The CEO is a veteran salesman with an established track record of commercialising new medical devices – we believe he can do it again.

We are sometimes discouraged by ASX listed healthcare companies whose operations are solely in the US. Often Australian investors are only presented with companies who are unsuccessful in raising capital in the highly sophisticated US venture capital market. OSP's ASX listing passes the idiot test as the device was developed at Monash University. The only reason the company has a US focus is due to the larger market opportunity. We are hoping for big returns from OSP however because it is yet to record a profit we have treated the position as speculative and limited our exposure accordingly.

Outlook

Smaller companies have outperformed the blue chip majors over the past 12 months, although they have underperformed since the GFC. Small caps tend to be stronger in the later phases of market cycles. There has been a notable increase of interest in the companies we tend to research. It seems the lacklustre outlook for the blue chips (mainly banks and diversified miners) in conjunction with decreasing returns on cash accounts is spurring interest in the 'growth' sector.

We seem to be in the midst of a small cap capital raisings boom. Companies with questionable prospects and inflated valuations are finding their ambitious share issues significantly oversubscribed. We are exercising caution and seek to create a portfolio which will perform under a multitude of market scenarios.

This month we welcomed Joseph Constable to the investment team, we are sure he will add value and look forward to introducing him to unitholders he is not already acquainted with. We continue to build several new positions and look forward to explaining these and existing investments 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 – 18 August 2016.

DISCLAIMER

Supervised Investments Australia Limited ACN 125 580 305 AFSL 317155 (SIAL) is the Investment Manager and Trustee of The Supervised Fund (TSF or Fund).

Investors should consider the TSF Information Memorandum (IM) issued by SIAL before making any decision regarding the Fund. The IM contains important information about investing in the Fund and it is important investors obtain and read a copy of the IM before making a decision about whether to acquire, continue to hold or dispose of units in the Fund. You should also consult a licensed financial advisor before making an investment decision in relation to the Fund. A copy of the IM and continuous disclosures may be obtained from http://supervisedinvestments.com

SIAL believes that the information contained in this document is accurate when issued. SIAL does not warrant that such information or advice is accurate, reliable, complete or up to date, and to the fullest extent permitted by law, disclaims all potential liability of SIAL and its associates. This document should be regarded as general information only rather than advice. In preparing this document, SIAL did not take into account the investment objectives, financial situation and particular needs of any individual person.

The information contained in this document must not be copied or disclosed in whole or in part without the prior written consent of SIAL, and SIAL accept no liability whatsoever for the actions of third parties in this respect. It is present for informational purposes only and is not to be construed as a solicitation or an offer or recommendation to buy or sell any securities. Any opinions expressed in this document may be subject to change. SIAL is not obliged to update such information. The information must not be used by recipients as a substitute for the exercise of their own judgement and investigation. Neither SIAL nor any of their directors, employees or agents accept any liability for any loss or damage arising out of the use of all or part of, or any omission, inadequacy or inaccuracy in this document.

SIAL does not guarantee the performance of the Fund or the repayment of any investor's capital. To the extent permitted by law SIAL, including its directors, senior executives, employees, consultants, advisors, officers and authorized representatives, are not liable for any loss or damage arising as a result of reliance placed on the contents of this document. SIAL only provides services to wholesale clients, as defined in section 761G of the Corporations Act. Past performance is not indicative of future performance. Information in this document is current as at 31 July 2016.