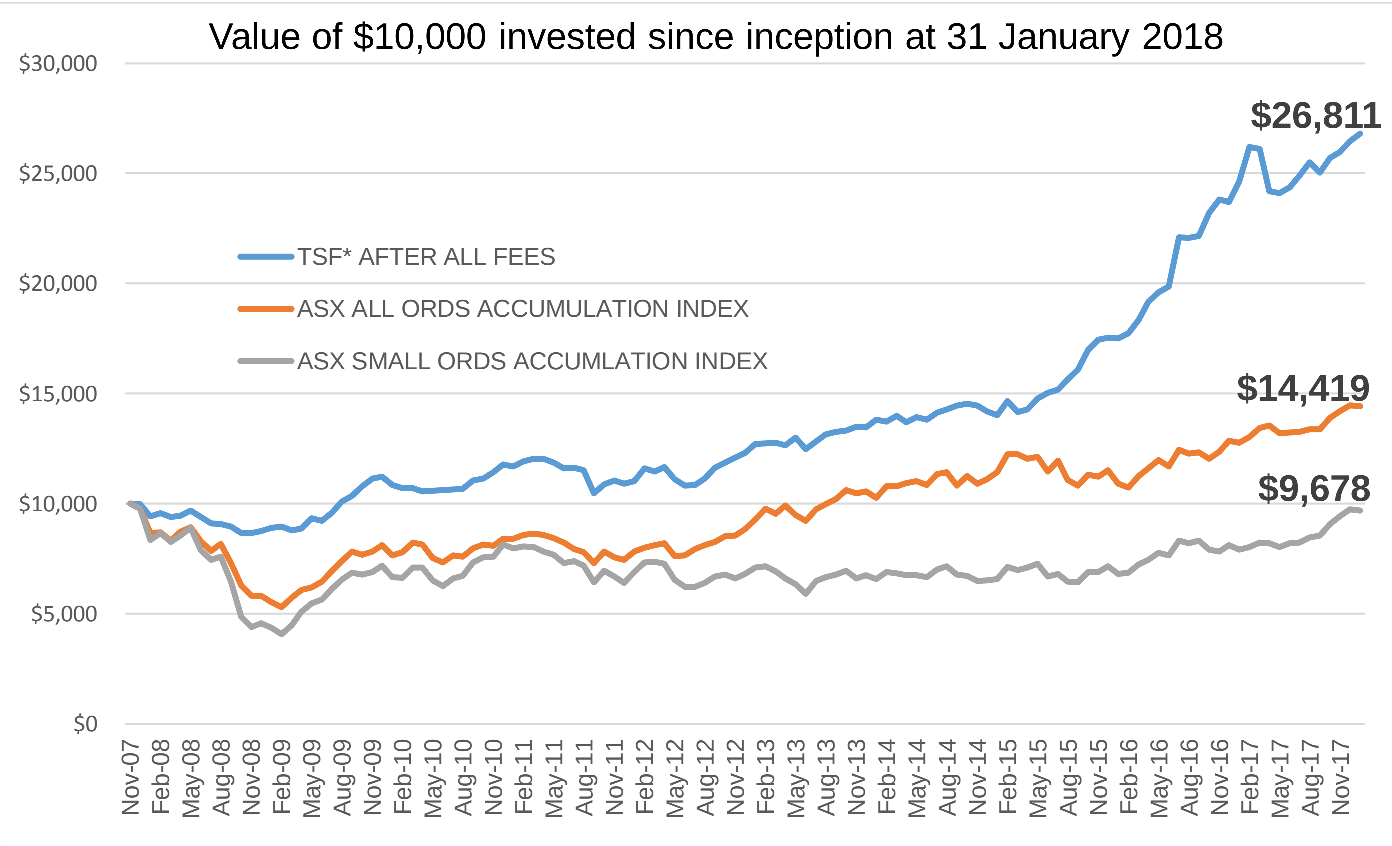
The Supervised Fund (TSF)

Monthly Report – January 2018

Performance Analysis (as at 31 January 2018)	TSF after all fees	Small Ords Accumulation	All Ords Accumulation
1 month	**1.3%**	-0.5%	-0.3%
12 months	**8.8%**	22.4%	13.0%
2 years p.a.	**22.9%**	16.6%	15.0%
3 years p.a.	**24.1%**	13.8%	8.0%
5 years p.a.	**16.1%**	6.4%	9.2%
7 years p.a.	**12.6%**	2.8%	8.0%
10 years p.a.	**11.0%**	1.5%	5.2%
Since inception p.a. (Dec. 2007)	**10.3%**	-0.3%	3.7%

Past performance is no indication of future performance



*Please note TSF return assumes reinvestment of all distributions (as do the indices).

Portfolio at 31 January 2018

Top 10 Positions	% of NAV
Kangaroo Island Plantation Timbers Limited	26%
Cash	15%
Hillgrove Resources Limited	12%
HGL Limited	9%
Po Valley Energy Limited	7%
Bisalloy Steel Group Limited	5%
Engenco Limited	5%
Physical Gold	4%
Bell Financial Group Limited	3%
Base Resources Limited	3%

- 0.2% of capital is invested in put options over stock market indices.
- 1% of capital is invested in non-ASX listed investments (excluding cash).
- 23% of capital is invested in oil, gas and resources companies (excluding gold).
- 5% of capital is invested in physical gold and gold mining companies.
- 67% of capital is invested in companies with market capitalisations of less than $150m.

Commentary

The Supervised Fund's December return of 1.3% was largely driven by increases in the share prices of Hillgrove Resources Limited (up 12%), Po Valley Energy Limited (up 9%), and Bisalloy Steel Group Limited (up 9%). Hillgrove's price continued to appreciate on no news, buoyed by sustained strength in the AUD copper price, which remained above $4/lb for most of the month. On the last day of January, the company released its report for the quarter ending December 2017. Copper production was 4,135 tonnes, the largest output since the quarter ending September 2015. Most importantly, output in December was the highest of any month since 2014. We expect this positive trend to continue, as mining has now reached the so-called "honey-pot" of the open pit, where the ore is copper rich and stripping ratios should reach near 1:1, compared with 2.2:1 in December and the project's average of 5.5:1. Consequently, the company should start to generate significant cash flow in the coming months. Once they have paid off their various creditors, likely by the middle of the year, the generated cash should fall to equity holders. There is still a further 42,000 tonnes of copper to be mined as per the mine life, plus any new discoveries. The company's guidance for total production in 2018 was above our expectations, at 22,000 to 24,000 tonnes. We were also pleased by their hedging, with 12,000 tonnes sold forward at A$8,740 per tonne (A$3.96/lb; US$3.11/lb). This represents over a quarter of Hillgrove's remaining output at the current seven-year high AUD copper prices of around $4/lb. We conservatively calculate Hillgrove generating A$140m of cash by mid-FY20. Discounted at 10% and subtracting $50m in debt and trade payables, this is worth around $70m to equity holders today, equivalent to 12.2c per share. This is before any exploration upside, and there appears strong potential in extending both copper and gold resources. Thus, we remain happy shareholders of Hillgrove and await further updates from the company.

Po Valley's shares had a volatile month of trading following two major announcements. The first was on 19 January, when the company reported the results of gas flow testing at its prospective Selva field. The results surpassed flow rate expectations by about 50% and demonstrated strong potential for an upgrade in resources. The market reacted exuberantly and by 10:10am the share price had reached 11c, up 175% from its previous close of 4c. This proved to be overzealousness, with the stock closing at 6.3c, still up 57.5% on the day with 13.6m shares traded, compared to a daily average of 96,000 in the prior twelve months. Two days later, PVE announced the terms of the binding agreement with London-based companies Saffron Energy and Sound Energy (see October 2017 performance report). The complicated transaction boils down to a reverse takeover of Po Valley by Saffron, which is additionally acquiring Sound's Italian assets. Saffron's consideration is 200m shares to Po Valley and 186m shares to Sound. Saffron will also conduct a placement to raise £14m, issuing 320m new shares. After the transaction, Saffron will be renamed Coro Energy Plc. Coro will wholly own all the gas fields currently owned by Po Valley and Saffron, as well as Sound's Italian gas assets. Crucially, it will have the funding required to pursue expansion in these companies' currently producing gas fields and continue the path towards production in their prospective fields. Po Valley will hold 300m shares in Coro (the 200m consideration plus its current 100m holding), equivalent to about 33% of the new company. These shares will be distributed *pro rata* to existing Po Valley shareholders. Accordingly, TSF, which owns 6.2% of PVE, will receive 18.5m shares in Coro. In addition, the fund will retain its 36.5m shares in PVE, which will have around $3m in cash, $11m in deferred tax assets, and receive a 5% royalty from production at Selva (a present value of around $2m). Due to the dilutive nature of the transaction, Po Valley's share price declined and ended the month at 4.3c (still up from 4c at 31 December 2017). We believe this is a significant discount to the inherent value of the stock. Applying a 10% discount to the predicted future cash flows to Coro from existing and imminent operations, the new company is worth about £50m, which to PVE, owning 33% of Coro, is 4.7c per share (A$1 AUD = £0.564). With the residual value of Po Valley at around $5m (0.8c per share) pre-tax assets, PVE shares are currently worth at least 5.4c (still a significant discount to the last traded price of 3.9c as at the time of writing). This is before exploration upside from current operations, as well as remaining gas assets yet to be drilled, for which Coro should have ample access to capital. Although dilutive, the transaction is an important step for Po Valley as it will provide the necessary funding for its assets and give shareholders liquidity (based on last year's average daily turnover, it would take us 380 days to sell our holding on-market). Consequently, despite the rollercoaster ride during January, we remain positive about our holding in Po Valley and will update unitholders as the transaction progresses.

Bisalloy's shares increased by 9% on no news. We await the half-yearly results this month.

The fund's largest detractor during January was HGL Limited (down 9%). The stock also fell on no news, with a mere 290,000 shares traded (a trade value of around $140,000), representing 0.5% of shares on issue. Such is the nature of an illiquid company with a market capitalisation of around $25m: when one or two people sell, the share price takes a disproportionate hit. However, despite the disappointment of seeing our third largest holding decline in value (even if temporary), it is worth noting that such exaggerated price movements in micro-cap companies are the very anomalies that allow us to buy undervalued stocks.

The month ahead

We are moving into a busy period, with the half-yearly reporting season beginning in early February. We currently have forty-seven company presentations in our diary to attend over the five weeks. These meetings provide a useful barometer for the sentiment in certain industries, the Australian economy as a whole, and equity markets. We will report on our findings in due course.

Thankfully, we have an extra pair of ears with the addition of Lachlan Kirwan to the fund's team. Lachlan worked for two-and-a-half years at multinational Mondelez, and recently completed a master's degree in accounting at the London School of Economics (see his bio here). Lachlan is joining us as an investment analyst. We warmly welcome him to the fund.

We noted in our last report that equity markets continued to attract high valuations, leaving few opportunities for value investing. In the last week, the S&P has had its first and third largest daily falls over the last five years: 4.1% on Monday and 3.8% on Thursday. Whilst there is no way of determining whether this is the beginning of a long-term sell-off or merely a short-term correction, we feel prepared for either outcome. 15% of unitholder capital is in cash, allowing us to take advantage of any overselling that leaves stocks undervalued. In addition, we have 5% in physical gold, as well as put options over the S&P.

David Constable, Portfolio Manager

9 February 2018

	TSF after all fees	Small Ords Accumulation	All Ords Accumulation
Since inception p.a. (Dec 2007)	10.3%	-0.3%	3.7%
Financial year to date	10.1%	18.1%	9.0%
Calendar year to date	1.3%	-0.5%	-0.3%
FY17	22.6%	7.0%	13.1%
FY16	32.0%	14.4%	2.0%
FY15	9.0%	0.4%	5.7%
FY14	10.6%	13.1%	17.6%
FY13	15.3%	-5.3%	20.7%
FY12	-6.8%	-14.6%	-7.0%
FY11	9.4%	16.4%	12.2%
FY10	15.1%	11.2%	13.8%
FY09	-1.7%	-28.6%	-22.1%

The Fund's benchmark is 5% per annum. Small Ords Accumulation and All Ords Accumulation are included for the sake of comparison to the predominant Australian equity indices.