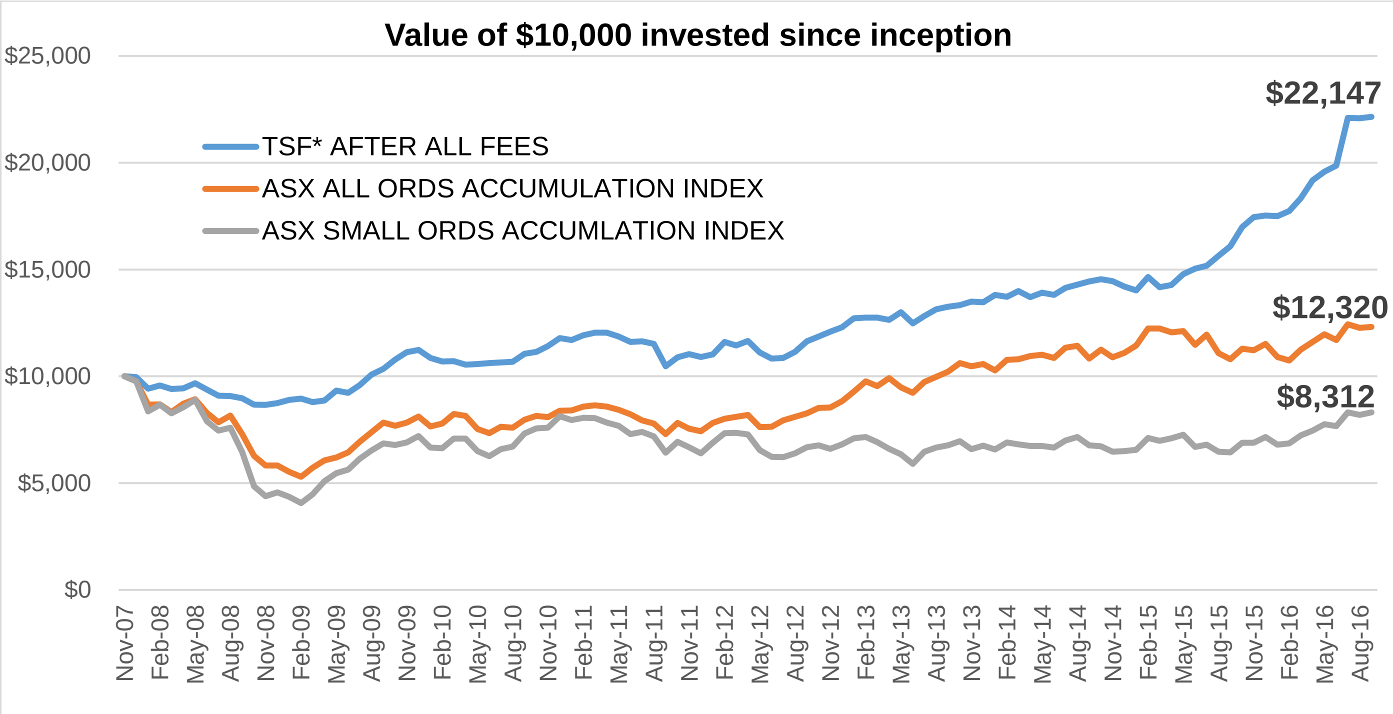
The Supervised Fund (TSF)

Monthly Report – September 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 30 September 2016	0.30%	0.40%	-0.10%
6 Months	20.76%	9.51%	11.25%
1 year	37.59%	14.01%	23.58%
3 years p.a	18.68%	6.42%	12.26%
Since inception p.a (since 1 Dec 2007)	9.42%	2.39%	7.03%



*Please note TSF returns assume reinvestment of all distributions.

At 30 September the portfolio was composed as follows:[1]

Top 15 Positions	% of NAV
Kangaroo Island Plantation Timbers Ltd	28%
Cash	12%
HGL Limited	9%
Bell Financial Group Limited	7%
Gale Pacific Limited	6%
Samuel Terry Absolute Return Fund	4%
Hunter Hall International Limited	4%
Base Resources Limited	3%
Po Valley Energy Limited	3%
Osprey Medical Inc – CDI	3%
Australian Vintage Limited	2%
Sirtex Medical Limited	2%
APN News and Media Limited	2%
Beadell Resources Limited	2%
Ramelius Resources Limited	2%

- 1% of capital is invested in (put) options over stock market indices.
- 2% of capital is invested in non-ASX listed investments (excluding cash).
- 4% of capital is invested in ASX200 companies.
- 7% of capital is invested in oil, gas and resources companies (excluding gold).
- 8% of capital is invested in gold mining companies.
- 72% 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.

Commentary

The fund slightly underperformed the local index during September. Our portfolio of 8 gold producers (8% combined weight) was up 9% and represented the largest positive contribution to the result. Australian Vintage Limited (up 7.5%) was the next largest contributor. Midway through the month we took the view a currency related earnings downgrade was likely at the upcoming AGM and sold half of our position accordingly realising a ~70% gain in less than three years. Despite the short term risk to earnings we still think AVG stock is cheap and are comfortable with our reduced 2% holding.

The largest negative contribution came from Kangaroo Island Plantation Timbers Limited (KPT) which we marked down by 2% to the price adopted by the company's Directors in a recent share issue[2]. At the day of writing this commentary, KPT has entered a trading halt pending release of an acquisition related announcement. As we detailed last month, the upside in this stock is contingent on the future existence of a deep water wharf on Kangaroo Island. If this proposed acquisition expedites a wharf development or maximises the company's claim over the island's timber resources, we expect the value of the stock could significantly exceed our carrying value.

Market Commentary

In our view a bull case for equities can be derived from the following observations:

- There is an improving outlook for US growth and employment.
- Anticipated increases in fiscal spending in Australia (and for that matter the US) are expected to maintain economic growth and help offset a declining contribution from mining sector capital investment.
- Corporate leverage is low compared to its 25 year average.
- Australian interest rates are unlikely to rise in the short term based on our (and most market participants') inflation expectation.
- The All Ords trades on a P/E of 17x – this implies a ~6% real earnings yield vs the 30 year nominal government bond yield of 3.2%. Recent rate cuts have spurred the cash rate to an all-time low, while the All Ords' dividend yield of 4.2% is in line with its 10 year average.
- Perceived international risk stemming from China's growing debt are seemingly unfounded given the government's significant net cash position and control.
- While the market is near an all-time high, it has been hovering around current levels for the last 12 months. Even if there is a coming crash, history suggests it will likely be preceded by a significant stock market rally.

In our view a bear case can be derived from the following observations:

- There is risk of other EU members leaving the block (our bet would be Italy) due to a poor outlook for growth, constraints on fiscal policy from EU membership, growing discontent over immigration and the ineffective nature of EU monetary policy. There is no quick fix to the solution and if more members leave there is significant risk of several sovereignties defaulting and an ensuing flight to safety.
- US inflation could surprise on the upside and force the Fed to raise rates faster than the market expects. US bonds have been rallying for 30 years – sovereign bond yields globally seem irrational. If the market begins to assume inflation will return to more normal levels bond prices could fall sharply and a corresponding panic may be felt in equities.

[2] We temporarily amended our carrying value methodology from a level 1 (quoted price) to level 3 valuation method (as defined by the Australian Account Standards Board) on the basis the ASX market did not represent an 'Active Market' as defined by the Australian Accounting Standards. The carrying value at 30 September represents a 13% discount to the last traded price. We expect to move back to a level 1 valuation in due course when we are satisfied the ASX market for the stock is 'Active'.

- Japan is conducting a monetary and fiscal policy experiment – there is risk the market loses faith.
- Geopolitical uncertainty.
- There is risk of a Chinese currency devaluation given rising labour costs and debts. This could impact the outlook for global growth and would be expected to have a severe impact on Australia's exports and property prices.

As always, we cannot predict the future. Our feeling is there a higher probability of the bull case prevailing or rather a situation where equity markets drift sideways. However, we certainly acknowledge the risks inherent in the bear points and the potential impact upon market sentiment.

In theory, gold producers rise with the price of gold, which in turn rises during times of uncertainty. With this in mind, we are satisfied with our 8% allocation to gold producers. Although the local gold sector has done very well over the past 12 months we maintain our allocation as a pseudo hedge against the bear case for equity markets.

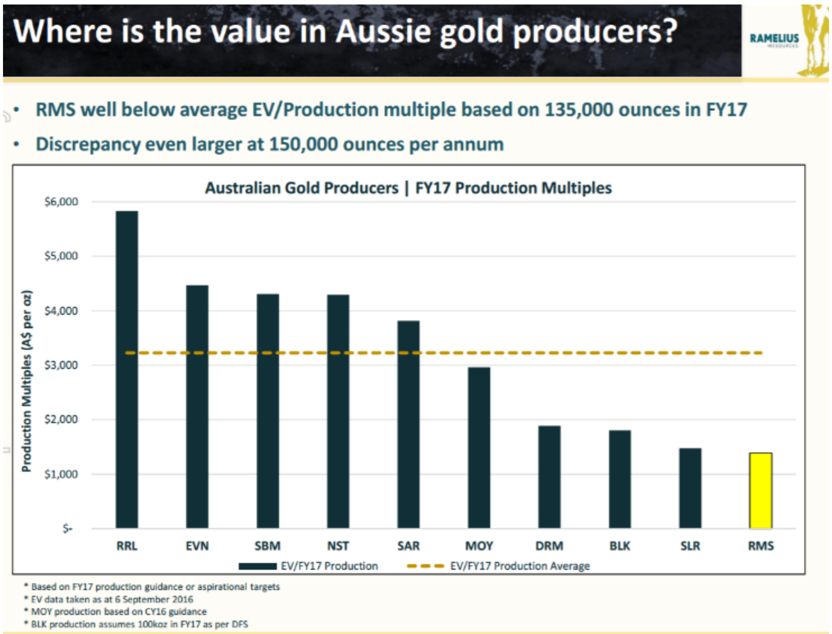
Ramelius Resources Limited (RMS) – 2% weight.

In line with the above thinking, our portfolio of gold producers prioritises firms with stable balance sheets, 'all in' production costs lower than USD900 (A$1,200), low CAPEX requirements and low risk mineralogy. Given we are not geologists and don't have a decent edge on interpreting drilling data, we have taken a policy of prioritising producers whose current valuation is cheap based on existing mine plans under the spot gold price.

RMS seems to fit these criteria. The company has a market cap near A$250m, net cash and gold of A$85m, $25m of available franking credits and a suite of gold plays (mostly) in the Western Australian gold fields. The company is due to invest ~A$50m in development CAPEX over the next several years in order to facilitate planned production. When we deduct this proposed investment from the enterprise value we derive an adjusted enterprise value near A$210m.

For the next 4 years, the company is expecting to produce more than 135,000oz of gold per annum at 'all in' costs less than A$1,100 per oz. At the spot gold price this will generate more than A$350m in cash. The management team has consistently beaten guidance over the past 2 years. Although current mine lives are only 4 years, resources imply a further 4 year extension is possible. Additionally, RMS has claim over several 'greenfield' and 'brownfield' projects, which could facilitate sustained production. The company is well funded to pursue these growth initiatives and the current price seemingly places zero value on such.

The company's short mine life and lack of a significant million ounce single deposit is perhaps an impediment for some investors. A key risk to our thesis is poor development choice or irrational empire building activities. The MD has voiced his intention to develop existing brownfield plays given the company's (low) valuation. If one takes the view RMS can successfully extend mine life without embarking on negative NPV projects the stock is very cheap compared to peers as illustrated in this chart produced by RMS.



Although the stock has had a good run over the past 12 months we remain comfortable with our position within the context of our gold strategy.

Mitch Taylor – 20 October 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 30 September 2016.