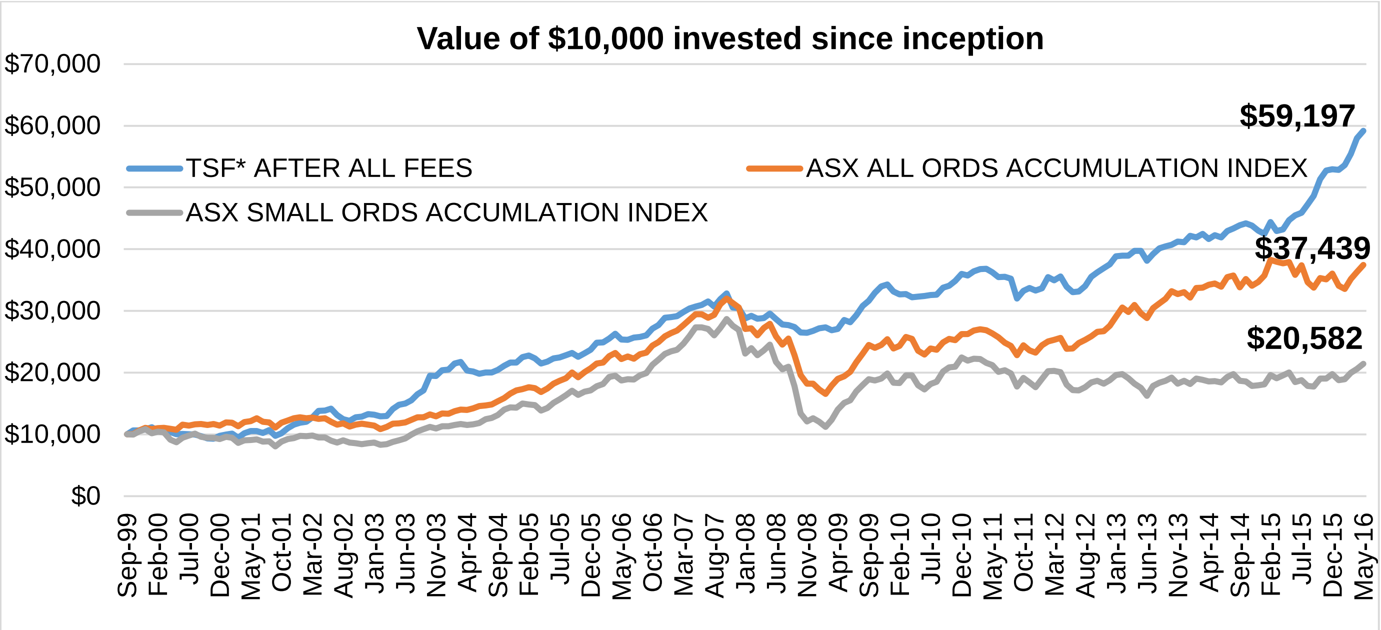
The Supervised Fund (TSF)

Monthly Report – May 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 May 2016	2.13%	3.09%	-0.96%
6 Months	12.20%	6.67%	5.53%
1 year	29.08%	-1.25%	30.33%
3 years (p.a)	14.22%	8.11%	6.11%
Since inception* (p.a) (16.5 years)	11.26%	8.24%	3.02%



*Please note the TSF returns include the previous USD denominated Supervised Investments Limited which merged with TSF in 2009.

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

Top 15 Positions	% of NAV
Kangaroo Island Plantation Timbers Ltd	28%
Cash	16%
HGL Limited	9%
Australian Vintage Limited	8%
Gale Pacific Limited	7%
Samuel Terry Absolute Return Fund	5%
Bell Financial Group Limited	6%
Hunter Hall International Limited	4%
Sirtex Medical Limited	3%
South 32 Limited	3%
BHP Billiton Limited	3%
APN News and Media Limited	3%
IMF Bentham Limited	2%
Base Resources Limited	1%
Molopo Energy Limited	1%

- 0.5% of capital is invested in (put) options over stock market indices.
- 4% of capital is invested in non-ASX listed investments (excluding cash).
- 10% of capital is invested in ASX200 members.
- 8% of capital is invested in oil, gas and resources companies (excluding gold).
- 75% of capital is invested in companies with a market capitalisation of less than $150m.
- 6% of capital allocated to companies with a balance sheet which fails our leverage tests.

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

Commentary

Global and local stock markets were up again during May, the Australian market was the second best performer amongst the majors. The RBA's decision to cut benchmark interest rates led the AUD down 5% against the USD, reversing a recent rally and presumably prompting a sigh of relief from policy makers and many corporate managers.

The Fund's performance was driven by late month rallies in several stocks. Australian Vintage Limited (**AVG**) rose 7% on the back of a positive vintage update, contributing 0.6% to the Fund's return. Base Resources Limited (**BSE**) rallied a spectacular 76% and contributed 0.8% to the Fund's monthly return. BSE rallied as the outlook for mineral sands prices improved, as we discussed here BSE is leveraged to any recovery in prices. Our largest holding Kangaroo Island Plantation Timbers Limited (**KPT**) rose 3.5% on no news, contributing a further 1.0% to the month's return.

PVE, 1% weight.

The biggest detractor from the Fund's performance was Po Valley Energy Limited (**PVE**), a tiny ASX listed oil and gas player with production and development assets in Italy. PVE fell 53% and cost 1.3% of unitholder capital. Since the end of May the stock has recovered 43% and at the time of writing is trading at 1c per share.

In June 2015 we participated in a placement at 7c a share. At the time PVE was in the process of finalising farm-out development financing deals with several of its gas plays. The deals had passed technical due diligence and major oil companies had signed heads of agreements subject to legal due diligence. We were intrigued as the deals seemed to imply the residual value of PVE's stake in the relevant assets was worth multiples of the company's market cap. Furthermore, these assets seemed to be unexciting compared to the company's flagship development asset which we were confident had significant value. We were not deterred by declining gas prices as we thought the company would still be valuable if Italian gas prices reduced 50%. However, because the company had negative earnings and a weakening balance sheet we limited the exposure.

The farm-outs fell over and the company was forced to sell assets to repay debt. The second sell off in global oil prices late in 2015 had minimal impact on the project economics but a significant impact on the banking relationship. PVE also suffered from a production set-back and a regulatory hold-up. By March 2016 the share price had dropped to near 3.5c and it was apparent the company needed more capital to continue. When the directors and founders proposed to personally underwrite a recapitalising 2.5 for 1 rights issue at 0.5c a share we had to decide whether or not to participate. We asked ourselves will we be throwing good money after bad or is this a compelling opportunity? Directors buying shares is usually a good sign, here we were seeing the directors hoping to invest their own money and take a 70% stake. In the end we decided to take our share of the issue and further underwrite some of the shortfall.

The issue price valued the enterprise at less than 2m euros which seemed cheap. We came to a 10m+ euro break-up value by discounting already discounted metrics the company received in very recent asset sales. In fact, the offer document and subsequent director commentary revealed one of the main reasons the farm-outs fell over was because the market valuation of the company was too low compared to the farm-out partner's assessment of value. The company has spent over 50m euros to get to its present state and has several near term prospects which could deliver significant value over the coming 24 months.

The board is currently undertaking a strategic review with intentions to realise value for shareholders in the medium term. While we are excited about PVE's prospects we consider the investment highly speculative and have limited our exposure.

APN, 3% weight.

During May APN News and Media Limited (**APN**) announced a major capital raising and proposal to demerge the New Zealand business from the Australian business. This latest developed followed from the company's stated intent to sell the Australian regional print media assets in February. The market liked the news and the stock rallied 21%, contributing 0.6% to the monthly return. We explained in our January 2016 report (available here) why we believed APN's traditional print media assets were dragging on the market's perception and valuation of the company.

In addition APN announced it is in exclusive discussions with Fairfax Media Limited to merge with its New Zealand businesses. While there is no assurance and such would require New Zealand regulators' approval, this transaction would result in substantial synergies and more value for APN's New Zealand business.

Over the past few months the Board has engineered a platform of growth assets and taken steps to reduce the debt burden. With a cleaner balance sheet and a suite of media assets with good growth prospects APN could experience a further rerating. The simplification of APN also makes a takeover bid from the largest shareholder, News Limited more likely in our view. We eagerly await the completion of both transactions and hope to report continued success with APN in the coming months.

Changes to the Fund

We recently issued a letter to existing unitholders advising them of the following changes to the Fund:

- Increase the investment management fee from 1.25% (plus GST) of net asset value per annum to 1.5% (plus GST) per annum.

- Modify the benchmark return from which the performance fee is referenced from the RBA cash rate plus 1% per annum to a fixed rate of 5% per annum. The performance fee will still be 20% (plus GST) of the Fund's outperformance above the Benchmark Return.

- Negative Performance fees will continue to accrue monthly, any negative performance fee accrual at the end of the financial year will be carried forward to the next year. However, where the total number of units on issue has fallen by 20% or more during a financial year as a result of investors redeeming units, SIAL may reset any accrued negative performance fee to a level that reflects the aggregate losses (relative to the benchmark return) existing investors of TSF have incurred.

These changes will become effective from 1 July 2016.

While we have increased the investment management fee, the operating expenses will continue to be capped at 2% (plus GST). If these changes had been in place for the 2016 financial year, unitholders of TSF would have experienced additional net returns in excess of 0.3% noting that past performance is not a guarantee of future returns.

It is our view that these changes represent a more attractive structure to current and new unitholders and we expect they will assist us to grow our business.

Outlook

Many market participants are growing cautious of rising US interest rates and the prospect of Britain leaving the European Union. It would be naive to think we have an informational edge on either of these matters, although we do think raising US rates would be a rational move[2]. If Britain does leave the European Union we don't believe the economic impact would be as dire as some media reports suggest (and note it would actually take more than 2 years to 'exit') however financial markets could become volatile from the prospect of other members leaving the union. In any event we are comforted our portfolio consists mostly of companies with strong balance sheets. We are also comforted by the downside protection our put option over stock market indices provides, here we have risked 0.5% of capital to have 10% of the Fund exposed to profit from a material sell off in global stock markets.

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 – 17 June 2016.

[2] We also think the fact Switzerland's 20 year government bonds are yielding negative rates is irrational!

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