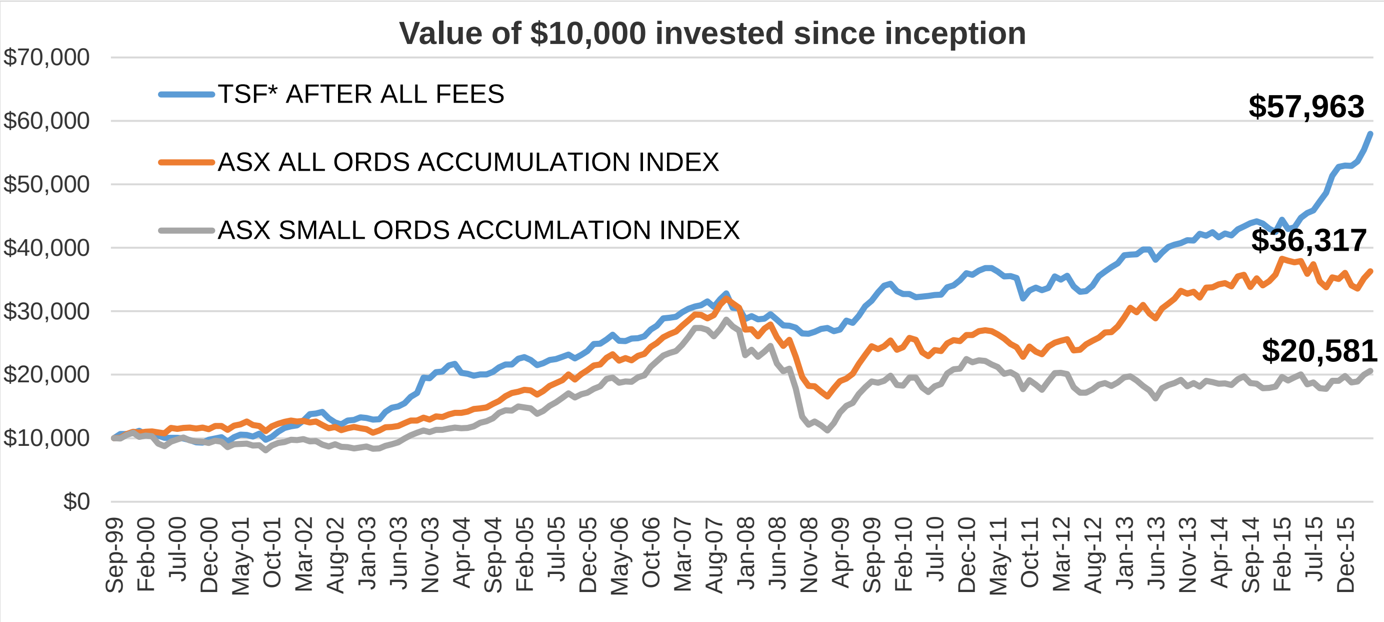
The Supervised Fund (TSF)

Monthly Report – April 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 April 2016	4.58%	3.24%	1.34%
6 Months	12.92%	2.76%	10.16%
1 year	34.22%	-3.65%	37.87%
3 years (p.a)	13.43%	5.43%	8.00%
Since inception* (p.a) (16.5 years)	11.18%	8.09%	3.09%



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

At 30 April the portfolio was composed as follows[1]

Top 16 Positions	% of NAV
Kangaroo Island Plantation Timbers Limited	28%
Cash	16%
Australian Vintage Limited	9%
HGL Limited	9%
Gale Pacific Limited	6%
Samuel Terry Absolute Return Fund	5%
Bell Financial Group Limited	5%
Hunter Hall International Limited	4%
Sirtex Medical Limited	3%
South 32 Limited	3%
BHP Billiton Limited	3%
Po Valley Energy Limited	2%
APN News and Media Limited	2%
IMF Bentham Limited	2%
Co-Operative Bank PLC	1%
Molopo Energy Limited	1%

- 1% of capital is invested in (put) options over Stock market indices.
- 4% of capital is invested in non-ASX listed investments.
- 12% of capital is invested in ASX200 members.
- 9% of capital is invested in oil, gas and resources (ex gold).
- 85% 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 equities.

Commentary

Global stock markets continued to rally during April 2016. Commodity producers were the best performing sector led by higher oil and commodity prices. The Fund's largest position, Kangaroo Island Plantation Timbers Limited (**KPT**), rose 15% and was the biggest contributor to the positive result. KPT still trades at a large discount to our estimate of its tangible asset backing and has no debt. We remain comfortable and confident in this position and look forward to providing an update in the coming months.

Co-Op, 1% weight.

The biggest detractor from April's return was Co-Operative Bank PLC (**Co-Op**), a UK based retail bank. Co-Op sold off 42% after it reported a worse than expected full year loss which was in turn driven by larger than expected redress provisions for historical misconduct. Additionally there has been speculation the UK regulator will force the bank to raise more capital. The argument for more capital is driven by a legacy pension plan the bank shares with its prior owner. The regulator may force the bank to hold excess capital despite the fact this pension plan is in surplus. The board is in the process of resolving the issue, if successful it seems likely the bank will not need to raise new equity capital and the share price may rise.

Co-Op is entering the second half of a 5 year turn-around strategy, aimed at transitioning the bank to generate sustainable annual earnings per share of £0.30 by 2019. At the end of April we had the stock marked at £0.90, implying large upside if the strategy is successfully implemented and underlying UK economic conditions remain somewhat buoyant over the next 3 years. We have faith in the board and activist institutional shareholder base and believe the turn-around strategy has been executed effectively to date. Because of the inherent risks of excessive leverage and a transient regulatory landscape apparent in all banking businesses (including Australia's banks) we limited our initial investment in Co-Op. It currently accounts for 1% of our capital. We think the stock is cheap and look forward to reporting on the short term catalyst.

IMF, 2% weight.

During the month we invested 2% of capital into IMF Bentham Limited (**IMF**). IMF was the world's first litigation funder and has an enviable track record of success. Since 2002 IMF has:

- Invested more than $250m to fund over 180 cases each with an average investment period of 2.4 years. Of these 180 cases IMF has only lost 13, resulting in a success rate greater than 90%.
- Generated an average gross return of 144% per funded case. This translates into an average net return of over 100% per case after accounting for IMF's overheads.
- Provided over $620m of proceeds to litigation claimants who would have been unlikely to receive any proceeds if litigation funding was not provided by an external party.
- Maintained a strict risk management policy which has seen the firm invest in less than 5% of cases presented and persistently maintained an industry leading track record.
- Maintained a stable balance sheet and generated an average return on shareholders' equity of 25% per annum.
- Employed highly rated professionals with multiple decades of directly relevant experience to manage and oversee case investments.

The share price has declined over 40% since March 2015 and now trades at our estimate of current book value. The share price weakness seems to be resultant of a string of losses, perceived comparability with the disastrous Slater and Gordon Limited, a rather complicated set of accounts, and the departure of some of the old management team 12 months ago. Today the market cap is approximately $230m, this is backed by over $100m in net cash and $120m invested across 47 cases.

We gained an understanding of the claims being sought where possible. One claim in particular made us quite excited. The company has brought a class action against the state of Queensland for financial loss or damage caused by the alleged negligent operation of the Wivenhoe and Somerset dams during a 2011 flood. Here we expect IMF will invest up to $20m, approximately 60% has already been deployed. If successful IMF could book pre-tax profits in excess of $100m. The risk of loss (and thus adverse costs) seems minimal given the outcome of several independent investigations, the key factor of dispute is the extent of damage resulting from negligent operation. We expect an outcome by June 2018.

However our own interpretation of the likelihood of winning individual claims is probably not valid - IMF consults with top QC's and has an investment committee with a much greater understanding of the relevant aspects of the law than us (and probably all market participants). If the current claim book results in returns equivalent to those historically experienced, the company will generate pre-tax profits in excess of $180m over the next three years. If this happens and management continue to source quality cases we think the stock will trade at a premium to the future book value meaning we could enjoy a handsome return.

The company spends $30m per year on staff and overheads, this means increases in average case duration and losses can reduce returns on equity and possibly force the company to raise additional capital. Because the investment cycle is so long IMF needs to make a minimum return of ~80% on each case to cover its annual overhead. We think there is a good chance the historical returns will continue. IMF is the clear market leader in Australia and is now an established player in the US and UK where it has employed experienced operators or partners; globally IMF is the third largest player. The market itself is experiencing growth which should ensure IMF continues to have adequate investment opportunities. In any event, it seems the stock is trading at more than a 50% discount to its three year run-off value.

We are comforted by the board's policy of holding enough excess cash to ensure funding commitments can be covered under perceived worst case scenarios over any two year period. We are also attracted to the lack of adverse cost risk apparent in the US expansion and the increased use of insurance products for adverse costs in Australia and the UK. Having interviewed the managing director several times we continue to be impressed with his and the underlying investment managers' attitude to risk. Perhaps the most unique attribute of this investment is the lack of correlation it has to other financial markets.

Many investors seem to be overly focused on the pending outcome of a claim against an Australian bank - the ANZ bank fee case. Although IMF is risking a relatively small proportion of its capital on this case (we guess about $8m) we expect this irrational focus by participants would cause the market cap to decline by more than $15m in the event IMF loses this case. It seems IMF has a 50/50 chance of winning this appeal, accordingly we have decided to wait for the outcome before allocating any further capital to this investment.

Outlook

We continue to build several new positions and look forward to explaining these 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 May 2016.

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