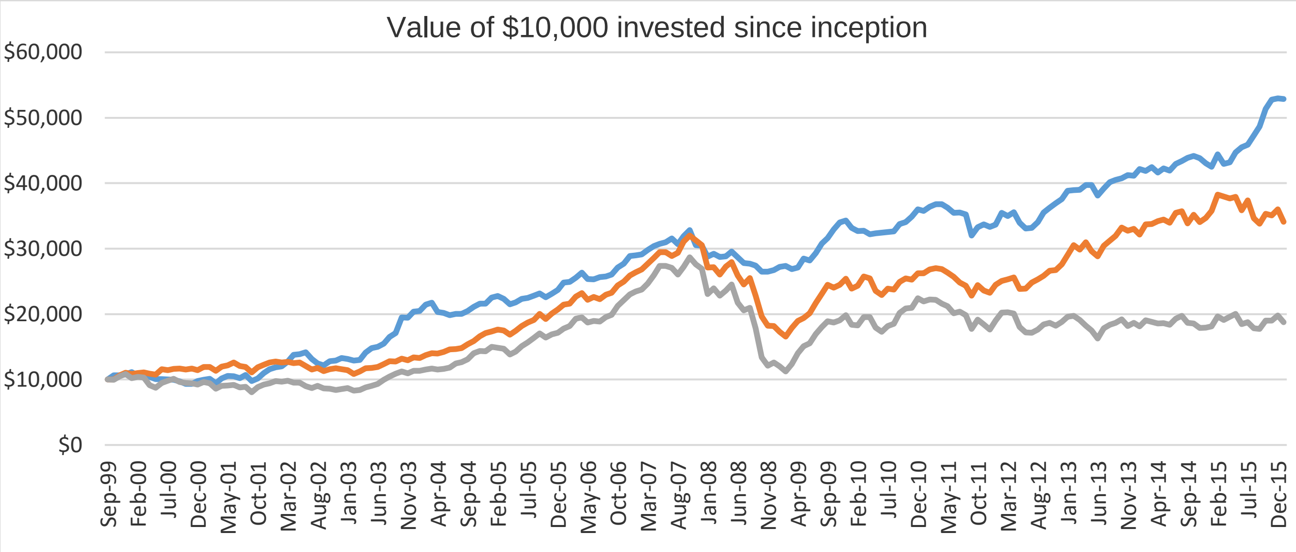
The Supervised Fund (TSF) – January 2016 monthly report

Dear unitholders,

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 Jan 2016	-0.17%	-5.38%	5.21%
6 Months	15.21%	-8.82%	24.03%
1 year	24.44%	-4.69%	29.13%
3 years (p.a)	10.83%	5.50%	5.33%
Since inception (p.a) (16 years)	10.73%	7.80%	2.94%



In the above chart the blue line represents an investment in TSF (after all fees), the grey line represents the Small Ords Accumulation Index and the orange line represents the All Ords Accumulation Index. Please note the TSF returns include the previous USD denominated Supervised Investments Limited which merged with TSF in 2009. Source: Bloomberg and Supervised Investments Australia Limited.

As at 31 January 2016 the portfolio was composed as follows[1]:

Largest Positions	% of NAV
Kangaroo Island Plantation Timbers Limited	27.5%
Cash and liquid receivables (net of fund liabilities)	11.1%
HGL Limited	10.5%
Australian Vintage Limited	8.0%
Gale Pacific Limited	6.7%
Samuel Terry Absolute Return Fund	5.1%
Bell Financial Group Limited	4.9%
Hunter Hall International Limited	3.9%
BHP Billiton Limited	3.5%
Sirtex Medical Limited	2.9%
APN News and Media Limited	2.0%
Co-Operative Bank PLC (unlisted)	1.9%
South32 Limited	1.9%
Molopo Energy Limited	1.5%
Other (across 12 positions)	8.6%

- No capital is invested in options over indices or currencies. There is no futures exposure.
- 5% of capital is invested in non-ASX listed investments.
- 8.3% of capital is invested in ASX200 members.
- 6.6% of capital is invested in oil, gas and resources (ex gold).
- 74% of capital (excluding cash) is invested in companies with a market capitalisation of less than $100m.

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

HOLDINGS COMMENTARY

APN

During January we invested 2% of your capital into APN News and Media Limited (APN). TSF previously held APN in 2012-2014 when we realised gross returns in excess of 80% over a 2 year period.

APN's traditional print media assets are in structural decline but command dominant market share in their respective markets and continue to generate significant cash flow. In recent years, the Board has invested these cash flows and expanded the group's footprint into radio, outdoor and digital media. In 2016, traditional print media will only contribute ~30% of group earnings.

Over the past 12 months the share price has cut in half and the company currently trades on a forward price earnings ratio around 7x. It seems there are 5 factors driving a negative sentiment:

1) The company reported weaker than expected first half earnings resultant of a lost outdoor advertising contract and ambitious margin expectations for the radio unit.
2) Elevated net debt levels near 3x EBITDA (or ~3.3x adjusting for off-balance sheet financing structures) stemming from recent radio acquisitions.
3) The outlook for traditional print media continues to deteriorate.
4) The perceived threat of disruptive innovation in the radio business.
5) An unexciting outlook for national advertising spend.

Upon investigating each of these factors it seems market participants have overreacted. We expect the company can reduce debt over 2 years through cash flow, don't view a deleveraging capital raising as likely, and are comfortable with contract risks. We don't expect material margin pressure in the ex-publishing businesses and expect management will continue to manage the decline of print media. The radio, outdoor and digital assets collectively exhibit attractive growth and earnings margins. We are expecting group earnings to grow at more than 5% p.a over the next 2-3 years.

At current prices, the stock is trading at a circa 25% discount to our estimate of a semi-distressed break-up value. There is a good chance the federal government will amend media reach rules within our investment horizon; such would enable News Limited (already a 15% shareholder) to make a takeover bid. News Limited could extract significant synergies from full ownership. They know the assets well, as APN's previous CEO was poached to run News' Asian operations 3 months after their initial investment.

2% of capital represents a half position for us, and we will add shares if we see mitigation of short term risks around debt and earnings momentum or if share price volatility creates a more attractive valuation.

BHP and S32

For the first time in years, we allocated a significant proportion of unitholder capital to ASX50 members. We invested 3.5% in BHP Billiton Limited and just under 2% in South32 Limited. Last month we articulated our view on commodity prices. Please click here to read last month's report. Our subsequent strategy is to invest only in companies which are cheap and do not require fresh equity capital even if commodity prices drop a further 15% and remain low for more than 5 years. We are particularly attracted to companies operating in the bottom 25% of the cost curve.

Over the past few months, we have spent time subjecting resource company valuations to our test. It seems many of the smaller companies are not adequately funded, do not have sufficiently long mine-lives to take advantage of future upswings, or their valuations imply an imminent bounce in commodity prices.

Both BHP and S32 meet all of our criteria. They are well run, low cost producers with sufficient funding to weather a long downturn and have cheap valuations. If commodity prices were to drop a further 15% and hold, we would expect managers to postpone growth CAPEX initiatives. This would enable enough cash generation and debt serviceability (for BHP) to satisfy reasonable valuations at present prices. As both vehicles have sufficiently long mine lives from current operations, we are satisfied that shareholders would benefit from any eventual upswing in commodity prices. There is ample media speculation regarding the sustainability of dividends in BHP in particular. While we acknowledge dividend cuts are rarely well received by market participants, we are not buying these stocks as a yield play but rather because their value is leveraged to commodity prices.

One of the risks with this allocation is poorly executed expansion activities. Mergers and Acquisition activities from the management teams of BHP and S32 have a track record of destroying value for shareholders. We are comfortable with this risk; we doubt shareholders would support M&A in the current environment. Even if they did, it seems value from mining M&A is inextricably linked to timing the cycle, and we continue to think we are closer to the bottom than the top of the commodity price cycle.

The current share prices suggest we are paying very little for the embedded upside volatility in commodity prices without incurring significant risk from further pain in commodity markets. It is very difficult to accurately forecast commodity prices but we expect BHP and S32 will trade at multiples of their current prices if and when prices do recover.

MARKET COMMENTARY

Global equity markets have exhibited significant volatility over the past few months. As of the date of writing, the local stock market index is off more than 7% for the year. Our unitholders capital value has remained intact throughout this period. We believe our portfolio is less exposed to general stock market movements than most[2], although we do expect returns correlation to increase during crises. The majority of our capital is allocated to companies where the investment case is less dependent on underlying economic conditions. The biggest risks we have to manage are usually company specific, associated with our high concentration of positions.

Some market participants have stated we will soon face a financial crisis scenario. While we don't think there is a crisis brewing, we do see likelihood of below trend global growth. We can't predict general stock market movements but acknowledge there could be continued pain in global markets in this scenario. We think our focus on the small end of the security spectrum can continue to produce positive results for unitholders in the current environment.

The fund is open to new investors and we welcome any queries on the portfolio, investment strategy and outlook.

Mitch Taylor and David Constable – 15 February 2016.

[2] Analysis of the of our fund historical returns compared to the underlying market reveals a correlation of less than 50% over a 16 year period. Past performance are of course no guarantee of future performance.

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