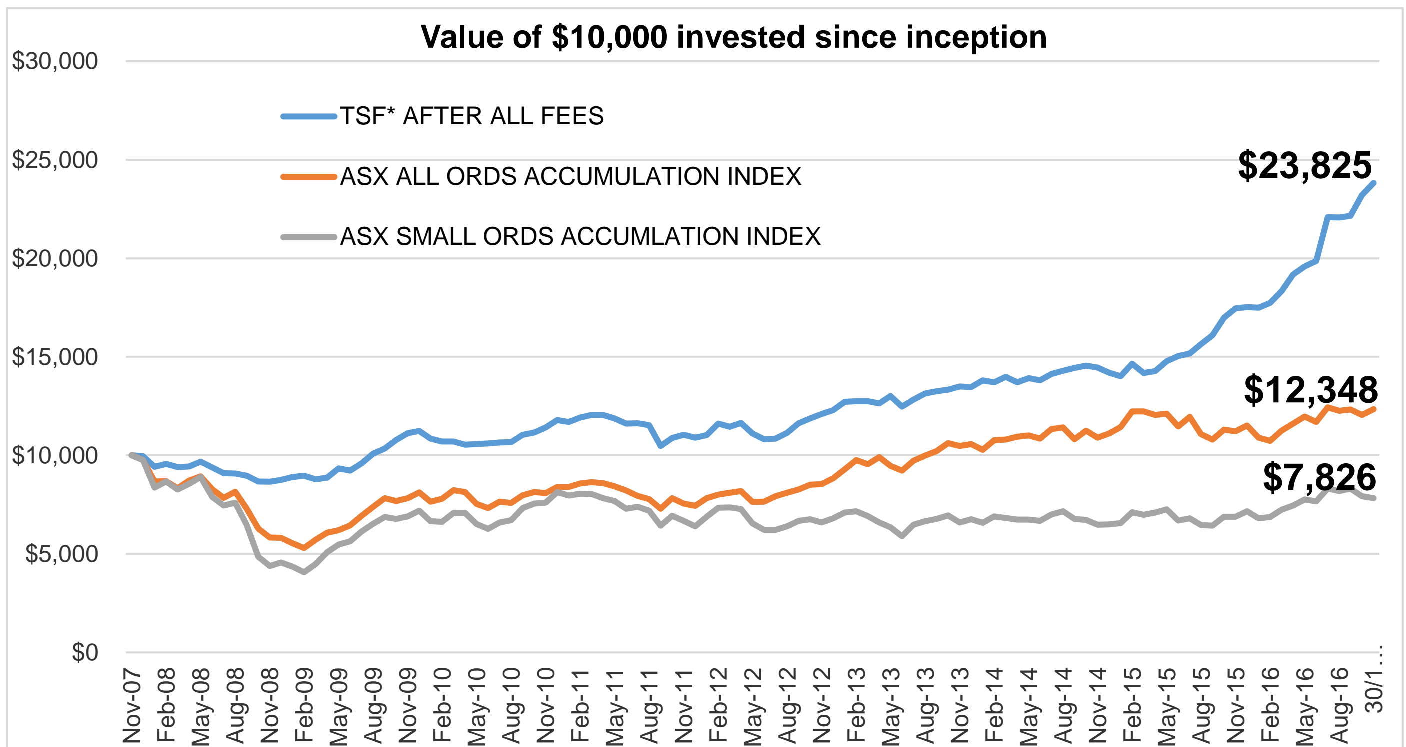
The Supervised Fund (TSF)

Monthly Report – November 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 November 2016	2.68%	2.46%	0.22%
6 months	21.64%	3.13%	18.50%
1 year	36.48%	10.01%	26.47%
3 years p.a	20.87%	5.64%	15.23%
Since inception p.a (since 1 Dec 2007)	10.13%	2.37%	7.76%



*Please note TSF returns assume reinvestment of all distributions.

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

Top 15 Positions	% of NAV
Kangaroo Island Plantation Timbers Ltd	34.4%
Cash	10.7%
HGL Limited	9.3%
Bell Financial Group Limited	5.9%
Gale Pacific Limited	5.4%
Samuel Terry Absolute Return Fund	4.5%
Base Resources Limited	2.9%
ETFS Physical Gold (AUD)	2.7%
Osprey Medical Inc - CDI	2.7%
Po Valley Energy Limited	2.5%
NZME Limited	2.5%
IMF Bentham Limited	1.8%
APN News and Media Limited	1.7%
Ramelius Resources Limited	1.5%
Hunter Hall International Limited	1.5%

- 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).
- 0% of capital is invested in ASX200 companies.
- 6% of capital is invested in oil, gas and resources companies (excluding gold).
- 6% of capital is invested in gold mining companies. A further 2.7% of capital is invested in physical gold.
- 68% 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

November was a volatile period for many financial markets as participants digested the implications of Donald Trump's victory in the US presidential election. Our portfolio was largely unaffected by this volatility, except for our gold allocation. Our **gold allocation** (6% in gold stocks and 2.7% in physical gold) cost the fund 0.6% during the month. As detailed here, our gold allocation is treated as a pseudo hedge against the bear case for equity markets. We believe it is prudent to maintain this position and added to it during November by investing 2.7% of unitholder capital in physical gold.

The biggest positive contributor for November was the Fund's second largest position **HGL Limited** (9.3%), which rose 18% after the company reported promising full year results and the Directors increased the dividend. 2017 should be a transformative year, we are expecting earnings growth in excess of 30%.The stock now has a forward P/E and fully franked dividend yield of 7.5x and 6.5% respectively, yet there is scope for continued growth beyond 2017. HGL trades at more than a 30% discount to run-off value, has net cash on its balance sheet, and franking credits sufficient to pay out fully franked dividends of more than the current market cap. We are not advocating a run off and believe there is more value in the current strategy, however are comforted by the inherent margin of safety.

Sirtex Medical Limited

Several unitholders contacted us regarding our exposure to **Sirtex Medical Limited (SRX)** after its share price spectacularly cut in half earlier this month - during November we sold our remaining 2% allocation in the company. SRX has been rewarding for TSF and at one stage represented 15% of the fund. We sold simply because the CEO sold 27% of his shares and released an announcement to the ASX "clarifying the reason for the sale of shares was to cover the tax incurred in relation to the recently vested tranche of rights". Six weeks after his sale the company released a profit downgrade and the stock opened 49% lower. We habitually follow Directors share trading activities and treat CEO share sales as a material negative indicator.

Despite the profit downgrade SRX is still a good company with excellent growth prospects. We bought back our 2% position earlier in December and have a small gain to show for it so far. At the price we paid SRX was trading on a forward P/E of 15x, yet it has above average growth prospects from its existing approved market and very significant growth prospects if large scale clinical trials yield positive results for 'first line' treatment. These trials are due to begin reporting comparative survival data early next year, our research suggests the odds are tilted towards success. If the trials are successful[2] the stock could trade at a multiple of its current price. If they fail to achieve the desired outcome, we expect SRX could take $20m out of its annual cost base which would generate 30% earnings accretion. The treatment has scope for use in other areas and the company has significant cash reserves which should ensure its survival.

NZME Limited

During November we invested 2.5% of unitholder capital in **NZME Limited (NZM).** NZM is a leading integrated New Zealand media company, reaching over 65% of New Zealand's population every day via its print, digital and radio assets. The company was spun-out of Australian based APN News and Media Limited (**APN**) in June this year and is now dual listed on the ASX and New Zealand Stock Exchange.

[2] As always with clinical trials, there are multiple degrees of success. In all of the scenarios we view as 'successful outcomes' the market opportunity increases by over 5-fold.

APN has been attempting to clean up its suite of assets to participate in any industry consolidation which may eventuate if our government amends the media reach rules. News Limited owns 15% of APN, and News' Asia boss was once CEO of APN - the logical play is for News to eventually bid for APN[3]. This is relevant because News Limited does not have any exposure in New Zealand and would not be interested in purchasing the NZM assets. Accordingly the reason for the divestment of NZM makes sense. When NZM was spun-out, the independent expert concluded a fair and reasonable value of $1 per NZM share. We rarely rely on independent expert reports because they are most often completed under the context of an empire building transaction where management is trying to convince shareholders to invest new money to fund 'growth'. In this case, the report was written for an empire destroying transaction where shareholders were effectively being asked to move assets from one pocket to another – $1 per share probably was 'fair and reasonable'.

NZM commenced trading the day after the *BREXIT* vote and was subsequently hit by a wave of sellers who presumably saw their new holding as too small to worry about. During the process, NZM announced it would merge with Fairfax NZ on desirable terms. The merger would generate ~$50m of combined cost savings and by far the largest media company in New Zealand[4] - the deal was subject to regulatory approval. During November New Zealand's Commerce Commission issued a draft determination blocking the deal, the stock subsequently declined below 50c and we started buying.

At 50c NZM has a market cap of N$100m and net debt of N$100m. The company trades on forward EV/EBITDA of less than 3.5x and dividend yield of 12%. Near 60% of EBITDA comes from the print media business which is seeing revenue declining at 10% p.a. Although the print business is in structural decline, it generates excellent cash flow which can be used to reduce debt and pay dividends. Market participants are concerned NZM will not be able to reduce costs and cushion the revenue decline, our conversations with industry players suggest otherwise. Even if the deal with Fairfax does not proceed, the two companies should be able to replicate nearly 50% of the cost synergies by entering joint venture and facility sharing agreements. Furthermore, NZM's management team is mid-way through a 3 year cost cutting initiative – the avenues for further cost-outs seem reasonable. We think print media assets are still valuable and expect they will continue to generate cash flow in 6 years time, albeit only a quarter of what they do now. We don't subscribe to the notion all print media assets are worthless because of eventual closure costs.

Our thesis with the print media division rests on the company's dividend policy – we expect NZM will pay out franked[5] dividends equating to 75% of our book cost over the next 5-6 years. By this time the print business will represent only ~35% of group EBITDA and net debt could be as low as $35m. NZM's radio business commands 13% market share, while its digital business is the fourth largest in the country behind Google, Facebook and Microsoft. Australian radio businesses have been trading at 8x EBITDA and have similar characteristics to NZM's radio assets. We think these businesses are inherently valuable and may eventually attract attention from market participants.

The merger with Fairfax would create considerable value and may still go ahead, we believe the stock is sufficiently cheap as a standalone to justify our purchase.

Mitch Taylor – 21 December 2016.

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[3] Such would make sense in the context of News' recent spree of acquisitions in the print media sector. APN's new suite of assets are all growing at above average rates. If News bought them, their growth rates would offset the declining revenue (but excellent cash flows) of the print media business and discourage market participants from viewing News as a 'value trap'. We also own APN!

[4] The independent expert did not assume the proposed transaction proceeds when recommending the deal.

[5] For Australian investors, these dividends will effectively be 50% franked.

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