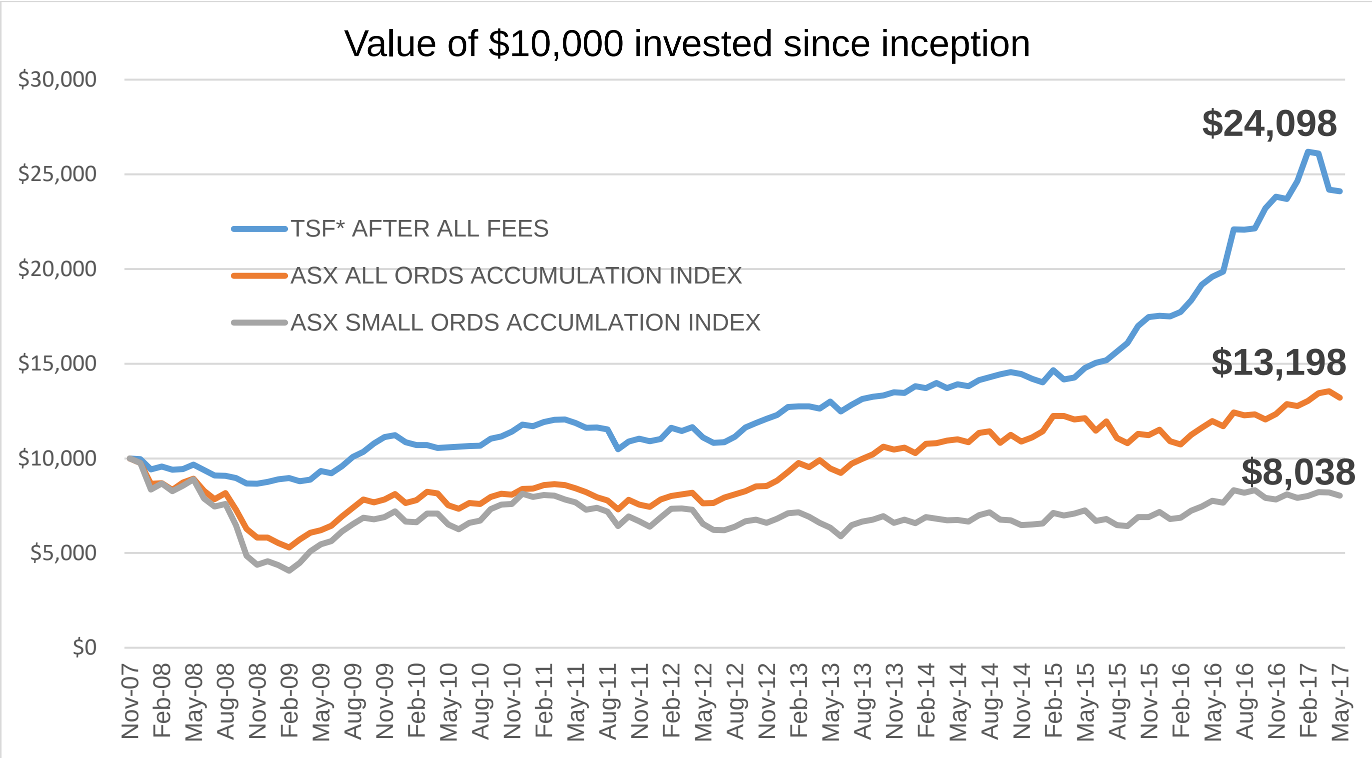
The Supervised Fund (TSF)

Monthly Report – May 2017

SUPERVISED INVESTMENTS AUSTRALIA

PERFORMANCE ANALYSIS	TSF AFTER FEES	ALL ORDS ACCUM	BENCHMARK
Month ending 31 May 2017	**-0.4%**	-2.6%	0.4%
6 months	**1.1%**	6.9%	2.5%
12 months	**23.0%**	10.2%	5.0%
3 years p.a	**20.8%**	7.4%	5.0%
Since Inception p.a (Dec 2007)	**9.8%**	2.6%	5.0%



*Please note TSF returns assume reinvestment of all distributions (as do the indices).

Portfolio at 31 May 2017

Top 15 Positions	% of NAV
Kangaroo Island Plantation Timbers Ltd	25%
Cash	15%
HGL Limited	11%
Hillgrove Resources (equity, notes and calls)	7%
Gale Pacific Limited	6%
Base Resources Limited	4%
ETFS Physical Gold	4%
Nine Entertainment Co Limited	4%
Po Valley Energy Limited	4%
Bell Financial Group Limited	3%
Ariadne Australia Limited	2%
NZME Limited	2%
UNDISCLOSED**	2%
Sirtex Medical Limited	2%
APN News and Media Limited	1%

** We have not yet finished buying this company, we will disclose once we have our desired exposure.

- 0.5% of capital is invested in (put) options over stock market indices.
- 2% of capital is invested in non-ASX listed investments (excluding cash).
- 7% of capital is invested in ASX200 members.
- 16% of capital is invested in oil, gas and resources companies (excluding gold).
- 7% of capital is invested in physical gold and gold mining companies.
- 56% of capital is invested in companies with a market capitalisation of less than $150m.

Commentary

May was a particularly difficult month for the Australian share market, which significantly underperformed most global indices. In our portfolio, positive contributions from HGL Limited (up 7.3%), Kangaroo Island Plantation Timbers Limited (up 3%) and Nine Entertainment Co Limited (up 6%) were more than offset by declines in Sirtex Medical Limited (down 24%) and Po Valley Energy Limited (down 17%).

HGL Limited

During the month HGL Limited reported a solid first half result and directors raised the interim dividend by 25%. Currently, most of HGL's earnings are generated from 2 business units although the remaining 4 owned businesses account for a majority of revenue. Management has done an enviable job stabilising the 4 laggard businesses and creating a platform for growth. We believe HGL is now at an inflection point and expect full year earnings to grow 18% this year and a further 13% next year. At current prices HGL has a market cap of $34m, no debt and trades on the following ratios:

- 2017: P/E of 9.6x, EV/EBIT of 8.2x, fully franked yield of 5%,
- 2018: P/E of 8.5x, EV/EBIT of 5.4x, fully franked yield of 7.1%
- 2019: P/E of 7.2x, EV/EBIT of 4.4x, fully franked yield of 8.8%

While we continue to back management's strategy and believe continued earnings growth will materialise, we find comfort in our view the stock trades at a discount to a conservative run-off valuation and the fact that the market cap is 30% backed by franking credits.

Sirtex Medical Limited

During May, Sirtex's share price declined as Phase III clinical trials for the company's sole product, SIR Spheres, failed to achieve primary endpoints of improved overall survival – the time it takes from first receiving treatment to death. The purpose of these trials was to prove SIR Spheres' suitability and/or superiority as a first line treatment for unresectable (inoperable) primary and secondary liver cancer and elevate the product from its current approved use as a salvage treatment.

A string of bad news in the 12 months preceding the trial results saw the company's share price cut in half. Clinical trial results are always difficult to forecast. Our research and conversations with medical practitioners led us to believe the odds of success were approximately 50%. The negative market sentiment was such that we thought the shares would at least double if the results were positive and only fall approximately 25% if the results were poor – the risk/return was asymmetric and we were comfortable with our exposure ahead of the trial results. The actual results were not clear cut,while the treatment failed to prove an overall survival benefit vs the current standard of care, they did show:

- Equivalence in overall survival
- Improved response rate of liver cancer tumours (slower cancer growth)
- Reduced toxicity, improved safety profile and better quality of life for primary liver cancer patients
- An overall survival benefit for those 40% of secondary liver cancer patients with liver tumours in the right lobe[1]

[1] This claim is not yet clinically significant and will require retrospective analysis of SRX's other clinical data to prove – this is likely to eventuate within the next 24 months.

- Increased resectability – prescribing the treatment to early stage liver cancer patients who have previously been diagnosed as inoperable can meaningfully increase the chance the liver cancer can be resected at a later date.

These benefits are material. Combined, they should enable the company to expand its claims and treatment approval. Presently, approximately half of Sirtex's unit sales are 'off label', meaning oncologists are/were pre-empting the usefulness of the treatment beyond salvage liver cancer. We believe the benefits are sufficient to facilitate continued use above salvage care and expect unit sales to grow over the medium term.

The end of clinical trial spend combined with present market scepticism should prompt a material decline in operating expenses. Previously identified cost-outs suggest the annualised operating expenses will decline at least 20% within 12 months. We expect sales to be flat next year but the cost savings to spur constant currency earnings growth of 20%+. Accordingly, Sirtex is currently trading on a forward P/E multiple of 12x and more than 10% of its market cap is backed by net cash - this is cheap given our expectation of sustained earnings growth.

Furthermore, we expect the new CEO will lodge patents and seek US legal enforcement limiting the ability of the company's sole competitor to continue 'piggy backing' off Sirtex's clinical data. Such could materially improve dose sales in the medium term and catalyse a share price re-rating. Accordingly, we remain comfortable with our exposure and optimistic about the company's future.

Outlook

Renewed expectations of earnings growth in large companies, a string of small company earnings downgrades and a ramp up in redemptions from some of our competitors caused a decline in many small cap stocks over the last 6 months. We are again finding value in our traditional hunting ground and are currently reviewing several interesting investment opportunities which we hope to report on in the coming months.

Mitch Taylor – 20 June 2017.

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