
FOCUSING ON WHAT COUNTS

Why business performance is all that matters

BANKS ARE CHEAP ELSEWHERE

International Fund buys into Lloyds Bank

OIL PATCHY

Tight budgets impact service providers

NO SALVATION IN CHINA

Why iron ore will stay depressed

SEPTEMBER 2014 QUARTERLY REPORT



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FOCUSING ON WHAT COUNTS

It is easy to get caught gazing into a financial crystal ball. Disparate returns for our two funds show why focusing on underlying business performance is far more important.

Dear Investor,

The three months to September produced contrastingly different results for the Forager Australian and International Funds. At home, the Australian Fund produced an 8% return in a quarter where the index went backwards a touch.

Although not of the same magnitude, for the International Fund the situation was reversed. The Fund's unit price fell 1.2% while the index increased 4.8%.

Performance

	1 Quarter	1 Year	3 Year (pa)	Since Inception (pa)
Australian Shares Fund	8.09%	8.73%	28.01% pa	13.77% pa
ASX All Ordinaries Accum	-0.29%	5.89%	14.04% pa	7.21% pa
International Shares Fund	-1.18%	15.17%	–	20.95% pa
MSCI ACWI IMI	4.81%	18.29%		24.47%pa

Long-term investors will be accustomed to lumpy returns. So what I am about to write will not be news. But with a significant number of new investors joining the Forager fold over the past 12 months, it is worthwhile reiterating what we do.

We don't try and pick stock price movements. We buy businesses that we think are cheap. And what determines our results is not short-term price movements but long-term business performance.

Michael Lewis recently wrote an article for Bloomberg titled *The Occupational Hazards of Working on Wall Street*. He talked in the article about the propensity for finance professionals to express opinions about things they know nothing about:

"Anyone who works in finance will sense, at least at first, the pressure to pretend to know more than he does.

It's not just that people who pick stocks, or predict the future price of oil and gold, or select targets for corporate acquisitions, or persuade happy, well-run private companies to go public don't know what they are talking about: what they pretend to know is unknowable."

Every time I am interviewed or receive questions in a public forum, I am asked what I think is going to happen to the Australian dollar, or how the Australian market is going to trade today. It gets a little tiring responding 'I don't know'. But it's the response I should give every time and it's the response you should give when you get asked the same question.

Our focus needs to remain steadfastly on finding cheap businesses and monitoring them closely to track their progress against our expectations of cheap. Here's an example.

In December 2011 we bought three million **Mirvac Industrial Trust (MIX)** units for the Australian Fund. The purchase price of this first lot was 7.6 cents per share, less than half MIX's net tangible assets at the time. We were confident the assets were worth their book values.

From the beginning, management had a plan to work towards an exit for Australian investors. Over the ensuing three years, they refinanced debt, sold some problematic assets and then put the remainder up for sale.

That process reached its conclusion in September this year when MIX announced it had reached agreement to sell the vehicle. Subject to a shareholder vote that is unlikely to cause problems, \$0.214 per unit will be returned to investors in December (see [page 12](#)).

MIX's unit price has moved around all over the place over the past three years. In some quarters it has made a significant positive contribution to the Australian Fund unit price, in others a negative contribution. But the final outcome is what you and we should be focussed on. We almost tripled our money in roughly three years. Whether that return shows up in the first year or the last is irrelevant, what matters is that we buy something for less than our estimate of its value and that our estimate turns out to be correct.

This works both ways of course. **Enero Group** has been a significant positive contributor to performance over the past year, but that doesn't change the fact that the decision to invest in it was a mistake. Looking back over our old research, the expectation was that Enero could generate \$200m per annum of revenue. This year it fell short of \$120m.

The stock price has more than tripled from its low point last year because the market dramatically over-reacted to the company's problems. Still, the business is quite clearly worth less than we originally thought.

Your focus and ours needs to remain on business performance, not stock price movements. Our International Fund oil services stocks were all down more than 20% on average (see [page 6](#)) during the quarter. Whether they are successful investments or not will depend solely on how much profit they make and the dividends returned to investors, not on any one quarter's share price movements. We might be wrong, of course. But we won't know that for a while yet.

CHINA'S CORRUPTION CRACKDOWN HITS HOME

Most Australian investors would think a corruption crackdown in China has little impact on life in Australia. Historically, you would be correct. Today, however, China is Australia's largest export partner and the power struggle under way in China has significant ramifications for this large island.

First, some background. In August, Zhou Yongkang became the latest 'tiger' to be snared by a corruption investigation. President Xi Jinping's crackdown on graft has been snaring 'flies', or low level officials, and high-level 'tigers' for more than a year. As Jonathan Feasby explains in the *Financial Times* however, Zhou, is the biggest tiger yet.

“WE DON’T TRY AND PICK STOCK PRICE MOVEMENTS. WE BUY BUSINESSES THAT WE THINK ARE CHEAP. AND WHAT DETERMINES OUR RESULTS IS NOT SHORT-TERM PRICE MOVEMENTS BUT LONG TERM BUSINESS PERFORMANCE.”

“Zhou is the highest-level target of a corruption investigation in the history of the People’s Republic. He heads an extensive clan network running through the internal security apparatus, the oil and gas industry and the Sichuan provincial government. The attack on him, and the scope and duration of the campaign, confirms the view that Xi is the most powerful Chinese leader since Deng Xiaoping and represents a new form of governance of the world’s second-largest economy.”

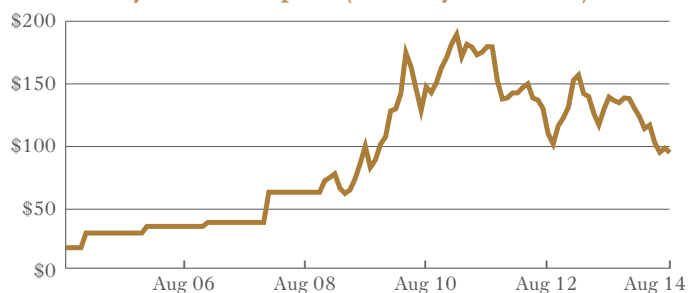
Xi’s corruption crackdown is important in and of itself. For the Chinese economy to continue growing it needs to allocate resources more efficiently. Less corruption would be a significant first step down that path.

But it is of far more symbolic importance. In his most recent newsletter, Michael Pettis explained why power is so important.

“It is no secret that during the past two or three years we have entered the most-heavily politicized stage of Chinese growth since the reforms implemented by Deng Xiaoping in the 1980s. This is not a coincidence. I have been arguing since at least 2010 that the very nature of the reforms China must implement means that it will be a highly politicized process, and will require tremendous centralization of political power.”

There are a lot of very rich, very well connected people in China who have benefitted enormously from the growth model of the three decades. Changing that model, away from State Owned Enterprises, away from debt-funded infrastructure and towards small business and consumption is going to upset a lot of people.

Chart 1: 10 year iron ore price (US\$/Dry Metric Ton)



Source: The Steel Index (TSI)

Which is why the political power to investigate one of the most powerful people in the country is so important. It suggests Xi and his fellow Politburo members might actually be able to pull the transition off.

And what’s that got to do with Australia? Well, Zhou Yongkang might not be a household name here but most people can probably tell you the iron ore price. The two are closely related.

The iron ore price is down because the Chinese economy is slowing at the same time as global supply is rapidly rising. If Xi has his way, it will slow further yet. Authorities have officially abandoned the 7.5% growth target previously forecast for the Chinese economy in 2014. If required to rebalance the economy, they seem willing to accept much lower growth rates in future.

That will mean less demand for Australian resources, less income for Australian governments and slower GDP growth or a recession.

Despite significant falls in resources-related stock prices, we remain cautious on the sector and the wider Australian economy. As you’ll read on [page 10](#), more than half the Australian Fund portfolio is invested in companies that own foreign assets or generate revenue in foreign currencies. Whilst we have benefited from that exposure already, we remain convinced that such a stance remains prudent.

If you are interested in investing [please visit here](#).

Yours sincerely,



“WHETHER THAT RETURN SHOWS UP IN THE FIRST YEAR OR THE LAST IS IRRELEVANT, WHAT MATTERS IS THAT WE BUY SOMETHING FOR LESS THAN OUR ESTIMATE OF ITS VALUE AND THAT OUR ESTIMATE TURNS OUT TO BE CORRECT.”

INTERNATIONAL SHARES FUND

FACTS

Fund commenced	8 Feb 2013
Minimum investment	\$20,000
Monthly Investment	Min. \$200/mth
Income distribution	Annual, 30 June
Applications/Redemption	Weekly

UNIT PRICE SUMMARY

Date	30 September 2014
Buy Price	\$1.3037
Redemption Price	\$1.2934
Mid Price	\$1.2985
Portfolio value	\$65.9m

INTERNATIONAL FUND PERFORMANCE

It's been a difficult few months. While most of the Fund's stocks have moved up along with the market, the three oil services stocks in the portfolio have fallen for a variety of industry and company-specific reasons. The carnage and opportunity are outlined herein.

Over the past month, a falling Australian dollar has been a tailwind to performance. But, thanks mainly to our proverbial oil spill, the Fund has underperformed the MSCI ACWI IMI over the past month (1.5% vs 3.1% for the index) and three months (-1.2% vs 4.8% for the index). Internally, we spend little time mulling over short term underperformance, which is as inevitable as the seasons, though unfortunately less predictable. The Fund also trails the index since inception, mainly because of its large average cash weighting in a roaring bull market.

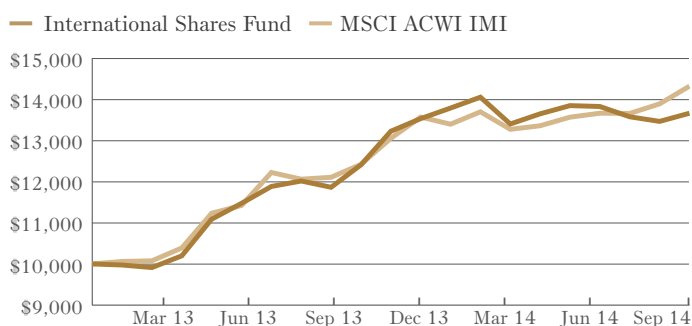
The team has been busy scouting the world for new opportunities, looking at many but declining most. That's as it should be. But over the past quarter, four stocks – three European and one American – were added to the portfolio. It's premature to discuss three of them. The most significant was an investment in **Lloyds Banking Group PLC** (LSE:LLOY) which is outlined below. The Fund also added to some existing positions.

Table 1: Summary of returns as at 30 September 2014

	International Shares Fund	MSCI ACWI IMI
1 month return	1.47%	3.10%
3 month return	-1.18%	4.81%
6 month return	1.95%	7.90%
1 year return	15.17%	18.29%
Since inception* (pa)	20.95%	24.47%

*Inception 8 Feb 2013

Chart 1: Performance of \$10,000 invested in the International Shares Fund



Source: Forager, Capital IQ

As a result, the cash weighting recently fell below 30% for the first time. We're getting closer to pulling the trigger on a few new investments in Asia, and have a much longer list of opportunities around the globe for when nervousness reigns.

LLOYDS: LIKE AN AUSTRALIAN BANK, ONLY CHEAPER

Many of the world's banks look cheap. No, not in Australia. But in the rest of the world you can find numerous financial institutions trading at substantial discounts to their net asset backing.

Lloyds Banking Group is not one of them. In fact, it is not even the cheapest looking bank in its home market of the United Kingdom (that prize probably goes to RBS). But of the many we have looked at, it is the one we have recently added to the portfolio. There are many reasons why.

'You're boring. Get used to it'. That's the message from *The Economist* magazine to the world's banks in its September 27 edition. Under pressure from regulators and shareholders since the financial crisis, banks around the world have been simplifying.

At Lloyds, that process is largely complete. It still has £30bn of legacy Irish property loans on its balance sheet, but that is a small percentage of its £500bn loan book and has been significantly written down already. It still owes customers an estimated £10bn for dodgy payment protection insurance sold in the pre-2008 years. And more recently the bank was slapped with a £218m fine for manipulating LIBOR, the benchmark rate used to price trillions of dollars' worth of loans and other financial instruments.

Chart 2: Portfolio distribution according to market cap



There could well be more to come but the legacy issues are getting smaller and the crisis, from which most of them stemmed, is getting further behind us. We're left with one very attractive business.

The Lloyds of today takes deposits from customers and lends the money out as loans (fancy that, a bank that takes deposits and makes loans!). There is no proprietary trading, no investment banking and, with 90% of its loans covered by deposits, minimal reliance on borrowing from other banks or wholesale investors.

The UK banking market was already concentrated prior to the crisis but, like Australia, consolidation during the crisis has left it even more concentrated. The top four banks in the UK provide 77% of personal banking accounts and 90% of business accounts. Lloyds itself has 27% of the retail market (31% if you include TSB, which is still majority owned by Lloyds but was recently floated on the stockmarket).

“THE TEAM HAS BEEN BUSY SCOUTING THE WORLD FOR NEW OPPORTUNITIES, LOOKING AT MANY BUT DECLINING MOST. THAT’S AS IT SHOULD BE. BUT OVER THE PAST QUARTER, FOUR STOCKS—THREE EUROPEAN AND ONE AMERICAN—WERE ADDED TO THE PORTFOLIO.”

As the folly of the pre-crisis years shrinks into the past, these market dynamics are starting to show up in Lloyds’ profitability. In the most recent half, the net interest margin (NIM) hit 2.4% (the difference between what a bank collects on its loans and pays on its funding). Its return on equity, excluding legacy issues, reached 16%. That’s a better NIM than Australia’s Commonwealth Bank and a return on equity only slightly lower.

All other things equal, we would still prefer to own CBA. The UK’s competition regulator is much more concerned with encouraging competition than its Australian counterpart. The Westminster politicians, too, see industry concentration as a problem that needs to be fixed.

None of that, though, justifies the difference in pricing. CBA trades at 15 times earnings and more than three times tangible book value. Lloyds you can buy for eight times earnings and 1.3 times book.

We have coveted this business for a while and a recent share price retreat leading up to the Scottish independence vote gave us our opportunity. We don’t expect to quadruple our money but Lloyds is one to add to the portfolio stable of attractively-priced blue chips. It makes up roughly 5% of the portfolio.

OIL PATCHY

Last quarter we claimed that equity markets seemed to be coming around to our way of thinking about the long-term future of oil and energy related stocks. We’ve put the champagne away and locked the cupboard – the price of Brent crude declined 15% over the ensuing quarter, and most oil-related stocks have fallen further.

Our three stocks are down roughly 20% over the month in local currency terms (Norwegian Krone). Because of the way the global oil industry operates, we view each investment as quasi-US dollar exposure. The 5% softening of the Krone over the month actually cushioned the stock price blow. In reality, it’s even worse than it looks. The sector is cyclical, and that means inevitable downs as well as ups. But our original thesis holds merit and, on the balance of probability and payoff, patience should prove the right course of action.

After years of heavy spending on exploration and development, oil majors have succumbed to shareholder demands and have tightened the purse strings. Rampant cost inflation over recent years has eroded returns on invested capital. Chart 3 shows a clear drop-off in return on common equity amongst oil companies since 2009 despite a relatively flat oil price.

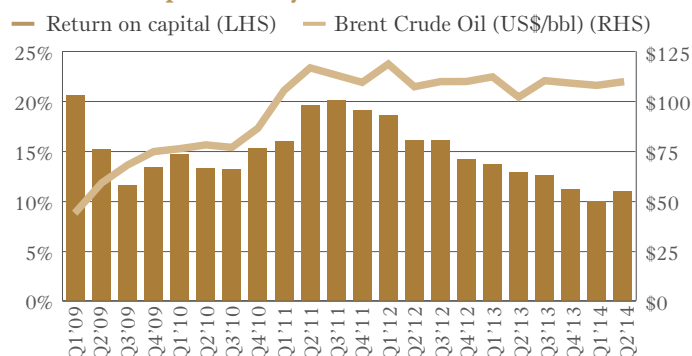
But anyone listening to the stream of Wall Street brokers pounding their Sell recommendations would be forgiven for thinking oil exploration and development is headed to zero. We struggle to recall such bearish sentiment on any large-scale industry in an otherwise ‘normal’ economic environment.

When the Fund bought shares in **Subsea 7** (OB:SUBC), the calls for oil company capex discipline were already quite loud. Many of the majors including **Statoil** (OB:TSL), **Total** (ENXTPA:FP) and **BP** (LSE:BP) had signaled their intent to scrutinise further investment. Subsea 7’s share price had already fallen

significantly in anticipation.

Over the last several months, commentary from management teams at Subsea 7 and its competitors have confirmed these fears. Major projects are being delayed, and clients are pressuring for better terms. The company has seen its backlog decline, and investors are concerned about how the company will fill its order book for 2016. As a result, Subsea 7’s share price has fallen 20% since the end of June.

Chart 3: E&P profitability



Source: Capital IQ

Our initial analysis anticipated the potential for such a development, but believed that an absolutely low valuation provided a margin of safety. As often happens in value investing, we were too early. While market sentiment has turned even more bearish, Subsea 7’s fundamental prospects remain robust and poised for improvement over the long term.

Oil companies cannot abandon deepwater well activity – they need to find and cultivate those reservoirs in order to replenish their reserves. Subsea 7 represents one of their only choices when it comes to bringing that production online. Most importantly from an investment perspective the seven times multiple of forecast 2014 earnings ratio seems absurdly low for a top class operator with a strong balance sheet.

Awilco Drilling (OB:AWDR) has also come under pressure as drillers face a deteriorating market. Eighteen months ago clients were quick to lock up rigs years in advance out of fear of capacity shortfalls. Unsurprisingly, drillers responded by ordering a flood of new rigs, set to enter the market in 2015 and 2016. Clients are now happy to wait to contract rig capacity and are much less willing to pay the exorbitant fees of recent years.

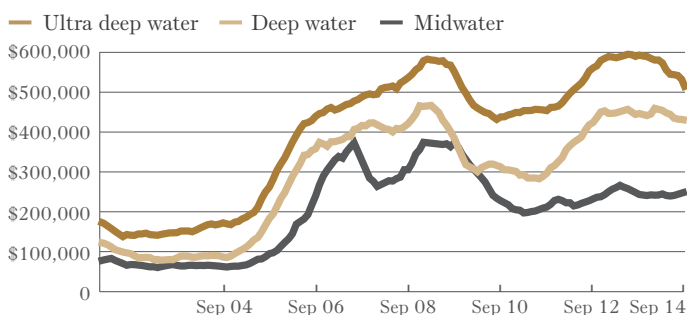
This development has been seen most acutely in the market for deepwater and ultra-deepwater rigs where the rates paid for their use have collapsed (see chart 4). While this trend does not directly impact Awilco’s rigs, which are much older, cheaper and used in shallower waters, it does send a signal to the market and tends to shape contract negotiations industry-wide.

The company’s rigs are contracted through 2015 and 2016, and they should earn plenty of money even at much lower rates. The stock price has also been impacted by uncertainty around the Scottish Independence vote, the spectre of increased

“BMW SOLD 36,000 CARS IN CHINA IN 2006 (JUST 8 SHORT YEARS AGO). IN 2014, THEY’LL PROBABLY ECLIPSE 450,000.”

taxation, and a sell down by the controlling shareholder. This unnerved the market and not without reason. But the price has fallen 22% over the quarter. We are happy to wait it out, receiving a 24% dividend yield in the meantime (although the dividend will need trimming at some stage).

Chart 4: Drilling rig daily contracting rates



Source: Arctic Securities

Finally, shares in seismic services provider **Dolphin Group** (OB:DOLP) have also been pummeled. Unlike Subsea 7 and Awilco, which operate mostly in development and production, Dolphin is more exposed to the exploration activity of its clients. Exploration spending is more sensitive to cutbacks making seismic demand more volatile. The market seems convinced that rates paid for Dolphin’s services will fall and pressure the company’s ability to meet its debt obligations.

While a levered balance sheet poses real risk, Dolphin runs one of the newest, most advanced seismic fleets in the world and has continued to win new business at a time when its competition has pulled back. Unlike most competitors, Dolphin leases vessels rather than owns them, providing significant flexibility to adapt its cost base to market conditions. Even at reduced rates, we expect a very profitable business.

Adding to the uncertainty, Dolphin has recently been acquiring more business in Russia which seems precarious given escalating economic tensions. A 45% decline in the share price during the quarter has undoubtedly been felt in the Fund’s performance, but the stock is one of our more compelling prospects. Trading at a measly 3.5 times forecast 2014 earnings, Dolphin’s valuation provides a very low bar over which to climb.

BMW: NO ORDINARY AUTOMAKER

Over the past month we’ve met with numerous companies in Italy and Germany. One of the more interesting visits was to Bayerische Motoren Werke AG, better known as BMW. Walking out of the meeting with investor relations, friend and former colleague Nathan Bell opined ‘It hadn’t quite dawned on me before, this is the most interesting time in the auto business since Henry Ford’s days’. He’s right.

China is the first explanation. As Chinese get richer, they want a car. And if they’re richer still, they want a German premium car. BMW sold 36,000 cars in China in 2006 (just eight short

years ago). In 2014, they’ll probably eclipse 450,000. It’s now the single biggest market for BMW, making up more than 20% of sales and more again of profit.

Barring Chinese economic meltdown, they’ll sell significantly more again in a decade. According to Global Insight, there were 15 million ‘premium-relevant’ households – BMW’s core market – in China in 2012. They expect that to triple to 46 million by 2025, 9% annual growth. Of course, forecasts are there to make fools of us all, but it’s highly likely that the Chinese market will become more important over the coming decades, with inevitable setbacks en route.

The other major shift is in the car technology itself. Electric vehicles are likely to go from new to mainstream, perhaps to dominant over the next few decades. Tesla currently leads the way but BMW is probably the best placed of the premium automakers and is improving quickly. It’s also working on semi-automation and full automation (driverless cars). Lightweight carbon fibre is replacing steel at the top end. The company’s proud engineering history and deep pockets (the auto division is sitting on €11.5bn of net cash) suggests it’s likely to lead rather than follow.

BMW is part automaker, part bank. An impressive bank at that. About 40% of retail buyers use some sort of financing from the company (loan or lease). Those loans and leases mostly stay on BMW’s balance sheet and are funded by bonds, bank loans and even personal savings accounts, popular with Germans concerned about the health of the country’s major banks.

Bought for the ‘sheer driving pleasure’, the borrower has a personal incentive to look after the main loan collateral, and these cars tend to retain significant value in the second-hand market. BMW drivers also tend to be more creditworthy than most. So, even in the horrible year of 2009, the credit loss ratio was below 1.0%. The spread between its loans to customers and the borrowings used to fund it, less all expenses, made up more than 20% of BMW’s net profit last year. This division is a gem.

BMW ordinary shares trade on a profit multiple of less than 10, and pay a 3.1% dividend. A smaller preference share has the same (actually slightly greater) economic rights and currently sells for 23% off the sticker price of the ordinary shares. It’s non-voting, but with various members of the Quandt family controlling almost 50% of the voting stock, those voting rights are hardly worth paying for.

The Fund doesn’t own any shares and there are significant risks to consider. Auto making is notoriously cyclical and we’re not at the bottom of the cycle today. China might face a substantial economic setback at some stage. Even the adoption of pricing parity in China would crimp profits substantially – it currently costs about 40% more for a BMW in China than Germany, although much of the difference is tax and transport-related. Tesla might genuinely revolutionise the market and be tough to compete against. The sharing economy – a model that might work particularly well with driverless cars – could mean far fewer cars needed on the road.

But this is a great business and one quite likely to be bigger and better a decade from now. It’s firmly on our wish list.

AUSTRALIAN SHARES FUND

FACTS

Fund commenced	31 Oct 2009
Minimum investment	\$10,000
Monthly Investment	Min. \$100/mth
Income distribution	Annual, 30 June
Applications/Redemption	Weekly

UNIT PRICE SUMMARY

Date	30 September 2014
Buy Price	\$1.4707
Redemption Price	\$1.4590
Mid Price	\$1.4649
Portfolio value	\$58.5m

AUSTRALIAN FUND PERFORMANCE

Australia's mining boom is well and truly over, with iron ore the latest commodity to nose-dive. The pain could be protracted but the Australian Fund is well placed to prosper through tough times.

IRON ORE: BUYER'S MARKET

The Australian Fund had a bumper September quarter, clocking up an 8.1% return in a period where the benchmark retreated a touch. Iron ore is the big driver of the market jitters; the spot price having now fallen a brutal 44% from its high of US\$137/t last year to US\$77/t at the end of September.

News to nobody, the insatiable demand for iron ore from China, which buys most of the world's seaborne iron ore, has moderated. But the real issue, at least from an Australian perspective, has been the huge amount of new supply added to the market over the course of the decade-long boom. Majors **BHP Billiton (BHP)**, **Rio Tinto (RIO)**, **Fortescue Metals (FMG)** and Brazil's Vale S.A. have all expanded operations and are producing record volumes.

Table 1: Summary of returns as at 30 September 2014

	Australian Fund	ASX All Ords Accum. Index
1 month return	-1.23%	-5.26%
3 month return	8.09%	-0.29%
6 month return	5.55%	0.18%
1 year return	8.73%	5.89%
2 year return (pa)	24.56%	14.38%
3 year return (pa)	28.01%	14.04%
Since inception* (pa)	13.77%	7.21%

*Inception 31 Oct 2009

The weight of all this supply has unsurprisingly pushed the price of iron ore lower, and the share prices of iron ore producers with it. But although the majors added most to supply, they have low-cost operations which afford some protection. Higher cost, marginal producers are the ones to suffer disproportionately. Northern Territory miner **Western Desert Resources (WDR)** recently went into receivership, and Chart 1 shows how **Gindalbie Metals (GBG)** has suffered more than Fortescue, which itself suffered more than Rio Tinto, one of the lowest-cost miners in the world.

Chart 1: Tough Going in Iron Ore

Rio Tinto	Fortescue Metals	Gindalbie
-13%		
	-40%	
		-67%

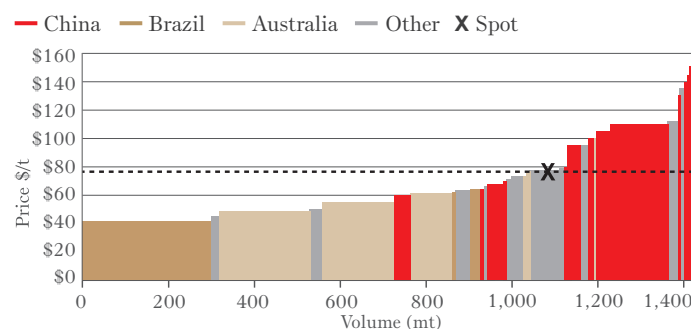
Source: Capital IQ

Perhaps there's one more ace in the Chinese stimulus pack in the short-term but the long-term outlook is decidedly grim. And, just as has happened in the coal industry, the response to lower prices could prove counterintuitive. Rather than immediate withdrawal of supply, some miners might increase production to try to reduce costs per ton and stay solvent. Smaller miners in particular are likely to produce as long as they have some cash, even at a loss, in the hope the market rebounds. This compounds oversupply. It could take decades for the market to rebalance.

NO SALVATION IN CHINA

The salvation many are hoping for is that higher cost Chinese producers will disappear from the market, relieving the pressure on price. Chart 2 shows the marginal cost of supply to China from both domestic supply and imports from Brazil and Australia (it excludes 'sunk' capital costs and makes no allowance for a return on investors' capital). In other words, it's an estimation of the additional cost to extract iron ore from the ground, ignoring the cost of infrastructure already in place. It's clear that China does indeed have higher cost mines (mainly because of poorer quality deposits).

Chart 2: Global Iron Ore Cost Curve



Source: Bloomberg

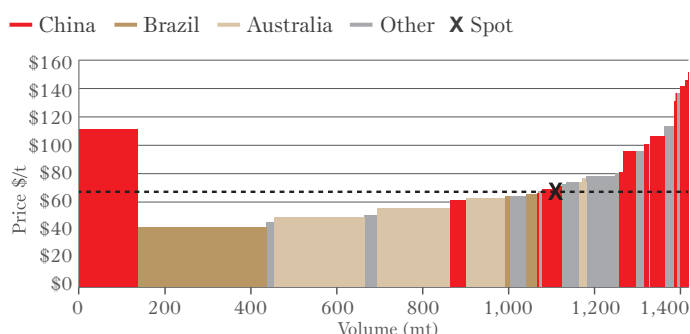
If China had demand of 1.1 billion tonnes next year, the cost curve suggests a marginal price of around US\$76 would clear the market. That makes most of China's domestic supply uneconomic. But whilst a private company might respond to big losses by closing down, the Chinese government has different incentives. It is a major consumer of iron ore and can benefit from tipping the market into oversupply, at least in the short-to-medium term.

As an example, suppose China commits to continue producing 135 million tonnes, despite incurring costs of \$110/t to extract it. If we move this supply to the front of the cost curve, you can see in Chart 3 that the new marginal price slips to US\$65. The benefit to China through reduced prices is US\$12bn (US\$11 per tonne for the full 1.1 billion tonnes of demand), while the cost is just US\$6bn on the loss making-supply (US\$30 per tonne for 135 million tonnes of domestic production).

What would you do if you were China? Australian miners banking on the withdrawal of Chinese competitors might be clutching at straws.

“BUT WHILST A PRIVATE COMPANY MIGHT RESPOND TO BIG LOSSES, CHINA HAS DIFFERENT INCENTIVES. IT IS A MAJOR CONSUMER AND CAN BENEFIT FROM TIPPING THE MARKET INTO OVERSUPPLY.”

Chart 3: Modified Iron Ore Cost Curve



GLOBAL PROTECTION

While the impact is felt most forcefully on projects, employment, and profits in the mining sector, the iron ore slump will also have a major impact on the wider economy, in particular state and federal government revenues. The surest protection for investors is to seek adequate foreign exposure, both to diversify from the Australian economy and to directly benefit from a weaker Australian dollar.

Table 2: Australian Fund foreign exposure

Stock	Currency Exposure	Details
RNY	USD	100% US commercial property
Hansen	USD, EUR	22% revenue from USA, 35% from Europe, Middle East and Africa
GBST	GBP	39% of revenue from UK
MIX	USD	100% US commercial property
Enero	GBP, USD	37% revenue from UK, 12% from USA
Infigen	USD	50% of revenue from US wind farms
Thinksmart	GBP	Some Australian cash, only operating business is UK based
Astro Japan	JPY	100% Japanese commercial property
Smart Parking	GBP	Parking management business, 90% of revenue based in UK

We've been sounding the alarm bells on the mining boom, the Australian economy and the potential for a weaker currency for a long time now. While the Forager International Shares Fund is an obvious play on the theme, we've been pleased by the value we've found in ASX-listed companies with foreign exposure. Software providers **GBST Holdings** (GBT) and **Hansen Technologies** (HSN) have been two of our strongest selections here and both reported excellent full year results, with earnings before interest, tax, depreciation and amortisation up 24% and 54% respectively.

But there are plenty more in the portfolio – companies included in Table 2 constitute half the Australian Fund portfolio. The \$A fell 7% in the quarter to US\$0.875 and we're well placed if it keeps falling.

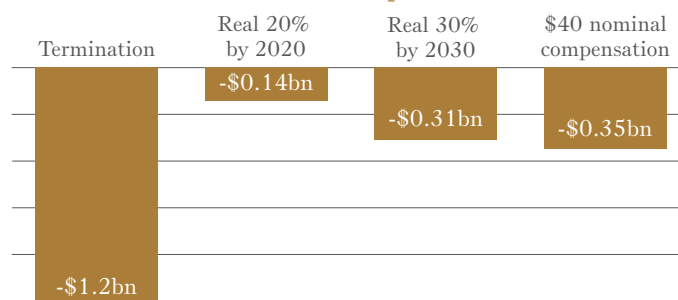
Another way to potentially benefit from the carnage in mining is to invest directly in the sector, which has gotten cheaper by the day. At the moment our investments are limited to mining services, in companies that look extremely cheap and have defensive qualities – production-oriented services, decent long-term contracts or substantial asset backing, for example. Holdings include **Macmahon Holdings** (MAH) and **Brierty** (BYL) which was our best performing investment in the quarter, up 47% on the initial investment including dividends. There's value around but there are also a lot of traps, and a lot of factors outside the control of each company. So we are keeping the aggregate investment in the sector moderate.

INFIGEN'S POLITICAL HEADWINDS

Wind energy producer **Infigen Energy** (IFN) has economic net tangible assets of \$590m, nearly three times its \$200m market capitalisation. Superficially this makes it very cheap. But with a whopping \$1.7bn in financial liabilities, and support required from a now-hostile Australian government, the situation is finely poised. Politics come into play because a major part of Infigen's revenue is derived from subsidies available to it from the Renewable Energy Target (RET) scheme. The RET, which supports renewable energy in Australia, is currently the subject of vigorous political and business debate. Critics, including most of the current federal government, view it as an expensive form of carbon abatement and an unnecessary burden on Australia's already oversupplied generation capacity.

A government-commissioned review recently recommended the scheme be downgraded or discontinued, and changes seemed likely. As Chart 4 shows, any changes could have a huge impact on Infigen's revenues over the next 15 years.

Chart 4: Possible RET Scenario Impacts



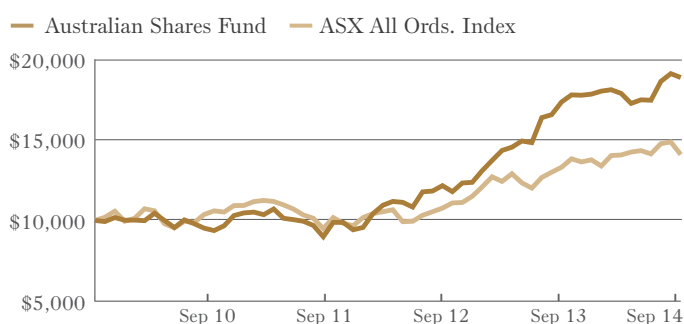
Source: Infigen Energy

The uncertainty has also had an immediate impact on the market price of the renewable energy certificates Infigen sells as part of its electricity production. The total ('bundled') price for uncontracted renewable electricity has fallen to around \$70/MWh.

“THE UPSIDE IS HUGE IF INFIGEN CAN REALISE ITS \$590M ASSET BACKING. IT’S A SMALL POSITION IN THE PORTFOLIO GIVEN THE LEVERAGE INVOLVED BUT ONE WE ARE WATCHING WITH INTEREST.”

For Infigen to have any hope of surviving its tighter loan covenants in 2016, it desperately needs that price to recover to \$100/MWh or more. Without regulatory support, this seems unlikely and a loan default is a real possibility.

Chart 5: Comparison of \$10,000 invested in Australian Shares Fund vs ASX All Ordinaries Accum Index

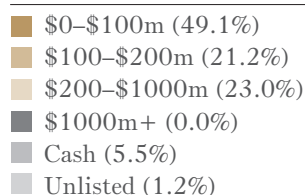


Source: Forager, Capital IQ

But all isn't lost yet. The RET is popular with voters and in a curious turn of events Senator Clive Palmer has become a defender of the scheme, blocking changes unless the Coalition government is re-elected with a mandate. With the more extreme potential changes seemingly impossible, the Coalition has reached out to Labor looking for a compromise and the talk of major change has softened noticeably. Even if changes are made, there is a good chance of compensation to protect the credibility of the Australian government in the eyes of private investors.

This is all positive news for Infigen, whose security price has rallied 27% from its mid-September low to \$0.26. It continues to be a high-stakes play with covenants bearing down, but asset sales in the United States could provide short-term flexibility if the long-term picture around the RET becomes clearer. As a final resort management is confident that, in the event of default, \$104m can be recovered from assets outside the debt facility.

Chart 6: Portfolio distribution according to market cap



That was a really interesting back-stop when the market capitalisation was \$150m, but today less so. Still some protection is better than none and the upside is huge if Infigen can realise its \$590m asset backing. It's a small investment given the leverage involved but one we are watching with interest.

WE WISH YOU WOULD ALL BE FRANK

Marketing conglomerate **Enero Group** (EGG) reported full year operating earnings before interest, tax, depreciation and amortisation of \$9.0m, up from \$3.6m the year before. That sounds impressive, but it's still a skinny margin, especially once \$3.3m in depreciation is accounted for. Net revenue fell 6% to \$119m, continuing a long run of shrinking turnover.

Nevertheless management commentary was upbeat and the stock price gained 9% in the quarter. As you can see in Chart 7, there has been a substantial rebound in sentiment since last year. The market capitalisation is now \$100m which, after adding back a number of non-recurring expenses, is still a little over twenty times current earnings. The market is baking in further improvements in margin and, as we've argued previously, there is some logic to it.

The statutory accounts show profits to non-controlling interests of \$1.5m, which is the founder's minority 25% stake in public relations agency Frank PR. This suggests that Enero's controlling 75% stake probably earned \$4.5m itself after tax. Frank PR accounts for only 10% of Enero's overall headcount but most of its current profit. It gives an idea of the potential for profit if a few of the other agencies start to fire.

They never seem to all fire at once, though, and we aren't convinced Enero is a bargain today. That contrasts with the situation last year, when the market capitalisation fell to a low of \$27m, scarcely more than the \$19m of net cash Enero had in the bank.

Chart 7: Enero's confidence dip



Source: Capital IQ

For those investors not familiar with the history of our investment in Enero, the initial buy decision was a costly mistake. It then presented us with a difficult, bias-tainted choice. Do we sell, clear the slate and move on, potentially falling prey to one form of bias? Or do we double down, grabbing a bargain and exposing your investment to another form of bias – commitment bias?

It's hard to know in the haze whether you've adequately countered all your important biases. The problem is so acute

“FRANK PR ACCOUNTS FOR ONLY 10% OF ENERO’S OVERALL HEADCOUNT BUT MOST OF ITS PROFIT. IT GIVES AN IDEA OF THE POTENTIAL IF A FEW OF THE OTHER AGENCIES START TO FIRE.”

that we know of fund managers that will sell their shares and then decide whether to repurchase in an attempt to clear their heads.

Table 3: Summary of major investments

Stock	Portfolio Weighting
RNY Property Trust	13.0%
Hansen Technologies	8.8%
Vision Eye Institute	7.2%
GBST Holdings	7.0%
Mirvac Industrial Trust	6.9%

For us, it was enough to face the previous mistake squarely and then take another look at the company as it currently stood. At \$27m it looked cheap to us, really cheap. To help insure against delusion, we ran the whole investment case past a colleague with no previous involvement for input. With that feedback received we gritted our teeth and bought more.

Mistakes are unavoidable. But thinking afresh after the initial insult and doubling-down when appropriate can sometimes pay off.

ASTRO CASHES IN, MIRVAC CASHES OUT

Japanese retail and office trust **Astro Japan Property Group** (AJA) cashed in on the low interest rate environment, refinancing of most of its debt with new ten year loans. The new loans require interest payments of 1.4% per annum. That’s hardly usurious but we’d expected closer to 1% in Japan. Manager Eric Lucas seems to be willing to pay a little more to lock in funding costs for a long period of time.

World interest rates will rise at some point, so that’s probably a good move. Reductions in principal repayments mean that Astro has upgraded its distribution forecast to 20–25 cents per unit, which equates to a yield of 4.5%–5.6%.

Astro also sold a potentially problematic retail asset for \$36m and has commenced an on-market buyback for up to 5% of its outstanding shares. The units are trading at a 25% discount to their net asset value (NAV) of \$5.94, so a buyback could add some value.

Unfortunately the fee structure is problematic, an issue that only gets worse as it sells properties and gets smaller. Management and trust fees consume 25% of the group’s profit before tax. It’s a significant drag and means Astro is likely to continue to trade at a discount to NAV. It either needs to get bigger or sell its assets and return the proceeds to unitholders. Lucas has shown himself to be a capable operator, avoiding large dilutive capital raisings and executing a string of value-boosting restructures since the financial crisis. But if offered close to net asset value for the stock, we’d happily take it. Astro units finished September at \$4.45, up a healthy 42% on our purchase price.

Lastly for the quarter, Chicago warehouse landlord Mirvac Industrial Trust (MIX), one of the Fund’s largest investments, announced a proposed scheme takeover for \$0.214 per security, after transaction costs. We’d been hoping for \$0.20 so it was a nice result. The sale will occur in \$US and, with the \$A having fallen since the announcement, the expected proceeds have edged up to A\$0.219.



Our earliest purchases of MIX were made in 2011 at \$0.075, so it’s been an excellent investment for the Fund. The unit price rallied 27% to \$0.21 in the quarter, which still leaves a potential 4.5% return for investors willing to wait a couple of months, depending on the currency movements. We doubt there will be any problems come voting time and the proceeds should be in the bank by Christmas.

“THE EXPECTED PROCEEDS HAVE EDGED UP TO A\$0.219. OUR EARLIEST PURCHASES OF MIX WERE MADE IN 2011 AT \$0.075, SO IT’S BEEN AN EXCELLENT INVESTMENT FOR THE FUND.”



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