31 December 2014

FORAGER

WRAPPING UP A ROUGH YEAR
Cheap money and ebullient investors are making life difficult for value investors.

BETFAIR'S DAY IN THE SUN
There are few sunny days in the life of a CFO. But this is one of those days.

SAYONARA JAPANESE BASKET
Our sell decision was as quantitatively-driven as the earlier buy decisions.

JUMBO EYES JACKPOT ABROAD
The share price has been hammered. To the point where we think it's absurd.

DECEMBER 2014
QUARTERLY REPORT

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WRAPPING UP A ROUGH YEAR

Cheap money and ebullient investors are making life difficult for value investors. As 2014 comes to a close, we reflect on our performance and why patience is more necessary than ever.

Dear Investor,

Both Forager funds produced mediocre returns in 2014. The Australian Fund returned 2.2%, roughly 3% less than its benchmark. The International Fund managed a slightly better 3.5%, but was walloped 10% by its index.

Performance

	1 Quarter	1 Year	3 Year (pa)	Since Inception (pa)
Australian Shares Fund	–3.39%	2.21%	24.59% pa	12.31% pa
ASX All Ordinaries Accum	2.58%	5.02%	14.30% pa	7.37% pa
International Shares Fund	3.03%	3.53%	–	19.80% pa
MSCI ACWI IMI	7.56%	13.52%	–	25.64%pa

We will have much worse years than that, of course. But the turning of a new year is always time for reflection, one where as investors we walk that fine line between learning our lessons and beating ourselves up too much about not predicting the unpredictable.

My reflections on 2014 fall into three main categories then. Things we got right. Things we got wrong. And things that are largely outside our control and will even themselves out in the goodness of time.

FIRST THINGS FIRST, THE STUFF UPS.

The International Fund's significant investment in oil services stocks has been extremely costly. The oil price itself I would place into the unpredictable category (see below) but, by definition then, we had a significant percentage of the portfolio invested in stocks where the main determinant of value was unpredictable.

That doesn't mean we shouldn't have invested, but it does mean we invested too much.

In Australia, our mining services investments were far too early. The Australian Fund hardly had any exposure at the start of the year, but managed to lose 6% of its net asset value due to investments in the space during 2014.

As we argue on page 11, it is always easy in hindsight. Of course we could have waited, but there are plenty of examples of stocks where we 'could' have waited but didn't and made a lot of money.

TOO EARLY TO THE MELT DOWN

Still, there is a lesson here. Those stocks that rose immediately were bought in what I would call a normally functioning market. Good businesses at reasonable prices from a seller who is not under duress.

The mining and mining services sectors are in melt down. A meltdown that we knew was coming (see for example "***China's unravelling starts to hit home***", "***The coming China crash: are we there yet?***" and "***China wobbles worth worrying about***") and spent the previous four years preparing for.

It is now a dislocated market where previously optimistic owners are selling shares without any consideration of price. They just want out.

Dislocated markets are where we make the bonanza returns, but doing so requires being selective and even more patient than usual. It is our view that we are going to make money on the initial purchase prices of these stocks and a lot of money from here. We could have made a lot more had we waited for the serious distress to set in.

Those two areas are where the bulk of the underperformance arose in the past year. Offsetting that, we've got a few things right.

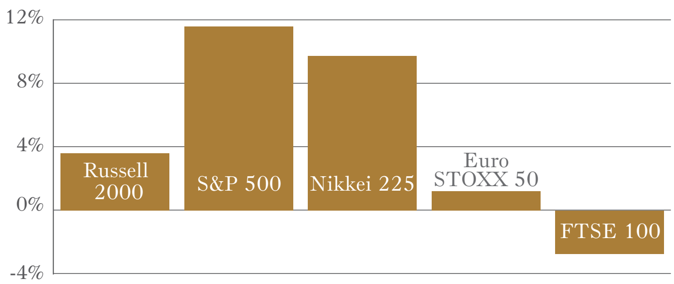
Forager's long-held view that Chinese economic growth would slow dramatically and a corresponding preference for businesses with foreign currency exposure has stood us in good stead. US industrial property group **Mirvac Industrial Trust** wrote the last pages in its life, the last few chapters of which have been very profitable for the Australian Fund. Other similar holdings have enabled us to sleep well at night while investors start to panic about the state of the Australian economy.

Our core US holdings continued to grow revenue and profitability. And a number of newer additions to the portfolios have performed well at both an operational and stock price level, including **Hansen Technologies** and **GBST** in Australia, and **Madison Square Garden** and **Betfair** in the International portfolio (see page 7).

It's important not to confuse luck with skill in a bull market. And I would like to see us find more of them. But our process for identifying high quality opportunities is producing good results.

Of the things outside our control, once again the international index performance was driven by large US blue chips. The large-cap dominated S&P 500 rose 12% during 2014, while the Russell 2000 – with a much heavier weighting to small caps – rose only 4%. The gap in performance was the **largest since 1998**. With a focus on finding unloved and underappreciated stocks, Forager's funds will always be underrepresented at the larger end of the market.

Chart 1: Relative stock market performance

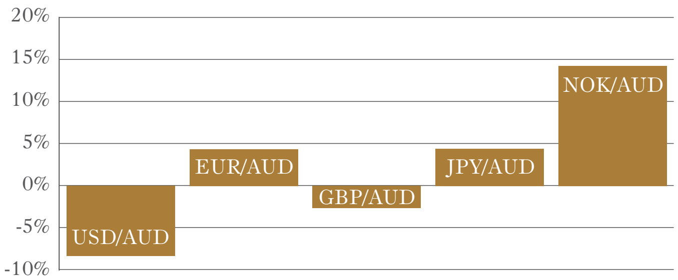


Source: Capital IQ

"WHILE MOST AUSTRALIAN COMMENTATORS HAVE BEEN ATTRIBUTING THE AUSSIES DOLLAR'S FALL TO CHINA AND COLLAPSING PRICES FOR OUR MAIN EXPORTS, THE TRUE STORY OF 2014 WAS ONE OF GENERAL US DOLLAR STRENGTH."

Secondly, while most Australian commentators have been attributing the Aussies dollar's fall to China and collapsing prices for our main exports, the true story of 2014 was one of general US dollar strength. While the Aussie depreciated 8% against its US counterpart and by 3% against the pound, it appreciated 4% against the Euro and Yen. On balance, currency provided only a minor benefit to the International Fund.

Chart 2: Relative currency performance



Source: Capital IQ

ELASTICITY OF OIL PRICES

Thirdly, the oil price halved between June and the end of the year. Post the event, pundits (as always) are writing about the precipitous fall like it was blindingly obvious at the time, but none of them were saying so in June. The 'supply glut' is hardly a glut in the traditional sense. Global oil production currently exceeds demand by an estimated 1–2%. But in a market like oil, small imbalances can cause huge movements in the market price.

If there is an oversupply of bananas in Australia, the market moves very quickly to redress the imbalance. Prices fall, consumers eat less other fruits in their diet and more bananas, moving the market back into equilibrium.

Chart 3: Oil Price in 2014 in US$/barrel of crude

Source: Capital IQ

In the oil market, neither demand nor supply adjusts quickly in the short term. Once an oil well has been developed, the marginal cost of a barrel of oil is very low. You are going to keep producing even if the price falls dramatically. On the demand side, behaviours don't change immediately. You can't swap your electric car for a petrol version just because the price of petrol is low.

Prices can, as we have seen, fall a long way without clearing the market, even when the imbalance is relatively small.

Over a longer period of time, both supply and demand are a lot more elastic. Consumers change their behaviour – sales of SUVs in the US have increased significantly in the past few months – and suppliers don't dig new wells at uneconomical oil prices. In the first week of January, 61 oil rigs were retired from work in the US, the largest decline in rigs in work since 1991.

The world needs new oil fields developed over the next five to ten years and our view remains that developers need a price of at least $100 a barrel to justify developing them. It will end up there in order to provide that signal, but where it trades in the short term is anyone's guess.

PLEASE SEND ME SOME PESSIMISM

Finally, perhaps most importantly, despite a few blips during the course of the year, global equity investors remain ebullient. That makes it hard for us to find bargains. Cash balances – particularly in the International Fund – have been a significant drag on performance. The reason equity markets keep rising is not difficult to discern. Interest rates around the world are at or near zero. Where else are you going to put your money?

That is an understandable reason for investing in equities. It is not an adequate one for us. Blindly chasing yield in riskier asset classes is a sure way to put a significant dent in your savings.

Thanks to turmoil in commodities markets, today's opportunity set is already better than it was 12 months ago. But we could do with more widespread pessimism in order to put our cash to work.

Whether in the next 12 months or the next 12 years, the tide will turn, equities will once again be viewed as unattractive and the prospective returns will more than compensate for the associated risk.

Until that point, we will strive to find what opportunities we can and eke out the best returns possible.

Yours sincerely,

STEVEN JOHNSON
Chief Investment Officer

“WITH A FOCUS ON FINDING UNLOVED AND UNDERAPPRECIATED STOCKS, FORAGER’S FUNDS WILL ALWAYS BE UNDERREPRESENTED AT THE LARGER END OF THE MARKET.”

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	31 December 2014
Buy Price	$1.3433
Redemption Price	$1.3326
Mid Price	$1.3379
Portfolio value	$69.6m

INTERNATIONAL FUND PERFORMANCE

Despite a rebound in December, It's been a tough quarter and second half of the year for the Forager International Shares Fund. The good news is that turmoil holding back returns in the short term is providing opportunities to put more cash to work.

Over the year to 31 December 2014, the Forager International Shares Fund returned 3.5%. It significantly underperformed its benchmark index, the MSCI ACW IMI, which returned 13.5%. Almost half this underperformance came in the December quarter (despite a good final month), when the Fund's 3.0% return lagged the index's 7.6%.

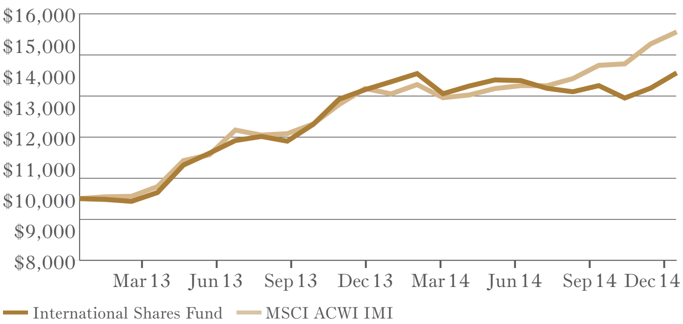
It's a disappointing outcome but one we don't intend to dwell on. Hopefully we've adequately forewarned that all value investors, indeed any type of investor, face inevitable patches of underperformance. It happened early in the Australian Fund's days, and now it's the International Fund's turn. Give it a few more years, and then we'll judge our longer term performance.

Table 1: Summary of returns as at 31 December 2014

	International Shares Fund	MSCI ACWI IMI
1 month return	3.63%	2.58%
3 month return	3.03%	7.56%
6 month return	1.81%	12.74%
1 year return	3.53%	13.52%
Since inception* (pa)	19.80%	25.64%

*Inception 8 Feb 2013

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



A chief explanation for the recent underperformance is the punishing our oil services stocks investments received because of the massive recent fall in the price of crude oil. See page 3 for more details. Our still large cash weighting, currently 31% of the portfolio, didn't help. In particular, being underweight US stocks hurt. The benchmark US S&P500 rose 12% over 2014, or more than 20% in Australian dollar terms. In wasn't a great year to be light on American stocks, but we follow our nose to where value lies, which has largely been outside the US this year.

Partly offsetting those bad news stories, the Fund had some decent wins like **Madison Square Garden Company** (NASDAQ:MSG), most recently outlined in the October 2014 report, and **Betfair** (LSE:BET), the case for which is outlined below.

With the recent return of jitters, we're looking forward to putting more money to work in the months ahead.

BETFAIR GETS ITS DAY IN THE SUN

"There are few sunny days in the life of a CFO. But this is one of those days". **Betfair** Chief Financial Officer Alexander Gersh was obviously happy with himself upon release of the company's half-year results in December. Those in attendance laughed and investors in the business agreed, sending the company's shares up 8% on the day.

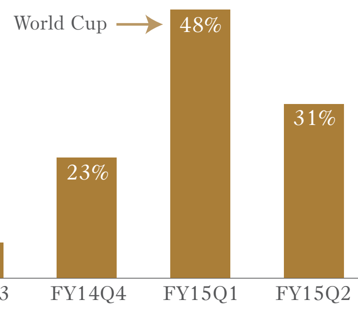
Betfair has also been a bright spot in an otherwise not so sunny half for the International Fund. Previously undisclosed, the Fund bought shares in August at an average price of £10.43 per share. By year end, the price had risen 51% to £15.72 (it's since fallen back a bit), and makes up 4.2% of your investment in the Fund.

The value on offer today is less obvious. But it's still pretty good value. Below we share the thought process behind the investment.

Helped by the soccer World Cup and a favourable run of luck, the half yearly result reported on Gersh's sunny day showed an increase in sales and operating profit of 26% and 51% respectively. But it's not just the profits that have him salivating. Not long after their appointment in 2012, he and CEO Brett Corcoran presented a new strategy for the struggling company. The latest results provide ample evidence that it is being executed brilliantly and, importantly, profitably.

Chart 2: Active customers, year on year change

Source: Betfair presentation



This online gambling company has always had a unique business model and a very significant moat. Like other bookmakers, online and offline, it offers punters the ability to bet on horse racing, sports and anything else they think there will be a market for. The difference is that Betfair doesn't take any of the risk.

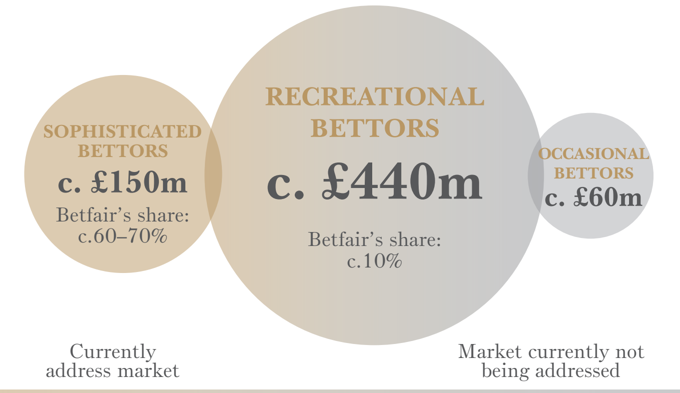
It operates an exchange – similar to a stockmarket – that allows two punters to bet with each other. Whereas a traditional bookmaker needs to earn a 'risk margin', to compensate it for potential losses, Betfair provides a platform for two people who want to take opposing sides of a bet and takes a percentage of the winner's profit. Traditional bookmakers typically require a

“AN ASTUTE MERGER WITH THE ONLY OTHER PLAYER OF NOTE IN 2001 GAVE BETFAIR SIGNIFICANT FIRST MOVER ADVANTAGES AND IT IS NOW THE WORLD’S LARGEST EXCHANGE WITH AN ESTIMATED MARKET SHARE IN EXCESS OF 90%.”

margin of approximately 10%. Betfair’s take averages of 3.7%, meaning the punters are getting significantly better value.

These better prices attracted a significant number of customers from the day Betfair was founded in 2000. For those who earn a living from gambling and are very price sensitive, using the exchange is a no-brainer. In a recent presentation using 2011 data, Betfair estimated it had 60–70% of the total UK market for ‘sophisticated bettors’.

Chart 3: UK online sports betting market



Source: Betfair presentation

The bigger an exchange is the better. The one downside of the model is that, on small or obscure events, there is often not enough liquidity for punters to bet the volumes they would like. An astute merger with the only other player of note in 2001 gave Betfair significant first mover advantages and it is now the world’s largest exchange with an estimated market share in excess of 90%. Liquidity is so important that this position is essentially unassailable.

Ten years of rapid growth led to the company listing on the London Stock Exchange at £13 a share. The fact that it is now turning up in a value investor’s portfolio should suggest to you that something went wrong from there. Indeed, it took more than four years for the stock to trade at its listing price again.

Betfair’s post-listing problems fell into two broad categories.

The first was regulatory. Betfair is a controversial business. Some of the controversy is effective propaganda from the threatened established players, some of it legitimate. The ability for people to short, or bet against something, makes it more susceptible to corruption and match fixing – it’s much easier to rig a loser than a winner. Betfair has always claimed it is not a bookmaker, so hadn’t been paying some taxes and industry fees. And the whole business model has been unwelcome in some countries. There’s been a crack down on Australia, Spain, Cyprus, Greece and Germany, forcing it to leave some markets and pay a lot more tax in others (Germany, for example, introduced a 5% tax on *turnover*, wiping out all of Betfair’s profit and forcing it to leave the market).

Secondly, the guys who founded and grew the business in the early days were not the right ones to run a large listed company. Betfair made £39m of profit on £300m of revenue in 2009. Even on an underlying basis, it was £30m of profit on almost £400m of revenue in 2013. This should, in theory, be a business where marginal revenue falls straight to the bottom line, but it was being run by entrepreneurs without much concern for the cost base.

The share price fell below £6 in 2011 and was still trading at less than £8 in 2012 when Corcoran and Gersh were parachuted in and tasked with planning the company’s turnaround. The strategy presented to market in early 2013 contained three key elements: run the business more efficiently; focus exclusively on markets with regulatory certainty; and seek growth in the market for recreational punters.

The first two prongs were obvious and relatively easy to execute on but it was the third that really piqued our interest.

Taking cost out makes the business more profitable and focusing on well regulated markets makes it more reliable. Even though the share price had been beaten up, growth was still necessary to justify the share price. And, with up to 70% market share among its key clients – those sophisticated bettors – and regulatory risk causing the company to withdraw from a number of international markets, it wasn’t obvious where that growth was going to come from.

Which is why cracking the market for recreational punters – three times as large as that for sophisticated bettors – is so important.

The recreational punters (Betfair wouldn’t say it but we can – mug punters) are not price sensitive and they find the Betfair exchange model complicated and confusing. Betfair’s market share here was only 10% in the UK, according to its own estimates.

Its plan for increasing that market share involves taking the benefits of the exchange model and packaging them in a user-friendly way that the mug punter can understand. The new interface looks like any other bookmaker’s interface and Betfair is actually running a traditional bookmaking operation offering fixed price odds.

But it uses its unique exchange to offer offers features such as “Price Rush” and “Cash Out”. The first involves providing the benefits of better prices by giving punters a bonus higher price at the time they place their bet (seamlessly matched on the exchange). The second allows them to cash in a bet that is in the money prior to the event finishing. For example, a bet on Manchester United before a game starts is going to be in the money if the team is leading 2–0 at half time. Cash Out allows the bettor to take their money and run if they think the situation is at risk of reversal. The simplified product is much easier to market to mug punters, while retaining the benefits of the exchange and leading to higher retention and higher turnover.

That’s the theory and it seems to be playing out in practice. In the second quarter of its financial year, the number of active customers was 31% higher than a year earlier and retention rates were improved.

"THE ABILITY FOR PEOPLE TO SHORT, OR BET AGAINST SOMETHING, MAKES IT MORE SUSCEPTIBLE TO CORRUPTION AND MATCH FIXING."

If the plan keeps working there is plenty of room to grow. That's why the CFO is so excited and why we bought the stock.

There are plenty of things that can temper his and our enthusiasm. While gambling is a resilient and growing industry, governments always have their hands out for a larger share of the spoils. The UK's new 15% point-of-consumption tax, introduced on the 1st of December, will have a significant negative impact on Betair's profitability. The company still generates 20% of its revenue from unregulated markets and, given they don't spend any money on this part of the business, it is presumably more profitable than the rest of Betfair's revenue. In the UK, like Australia, competition for new mug punters is fierce. And, of course, there's that 51% share price rise since the Fund's initial purchase.

But the Betfair model is unique, hard to replicate and difficult to compete with. Our bet is that there are plenty of sunny days ahead for Gersh and his shareholders.

SAFE HAVEN AT FLUGHAFEN ZÜRICH

The Fund first acquired shares in Zurich Airport in mid-2013, at around CHF495 per share. It finished 2014 trading at CHF667. We recently revisited our investment thesis afresh to see if it was time to sell part of the holding, which currently makes up 3.5% of your investment in the Fund.

Our long term expectation is for humble passenger growth to translate into decent revenue growth which, through the power of both operating and financial leverage, will convert to good profit and cash flow growth.

In recent months, passenger numbers have been growing faster than our expectation. Over the five months to 30 November 2014, total traveller numbers are up more than 4% versus the same period last year. Origin and destination (ie non-transfer) passengers – the more profitable kind – are up faster still, around 8%, because of a 'substantial increase in local demand'. This will boost 2014's profits and, if sustained, 2015's even more so.

The group also made a final commitment to The Circle, a large property development immediately adjacent to the airport and its massive public transport interchange. The project has significant, high quality lease commitments, with site preparations to start this month and the first phase to be complete in 2018. With sensible use of debt, we think the airport can make 12–14% equity returns on its joint venture investment – a lot better than you'll get on any property investment elsewhere in Switzerland. Development comes with risk, but they look manageable here. For now, we've decided to maintain the full position.

SAYONARA JAPANESE BASKET

One of the Fund's earliest purchases was a basket of statistical bargains in Japan (see **March 2013 report**). Inspired by Benjamin Graham's investment approach, we found and purchased 25 stocks trading at more than a 40% discount to net working capital (cash, inventory and receivables less all liabilities). Graham, who called these plays net nets, ignored the value of long term assets such as property and machinery, and anything as flippant as goodwill. We did likewise, furthermore expressing a preference for profitable, dividend-paying net-net bargains as an additional safety. We bought a few additional stocks along the way (see **December 2013** report), sold a few and had one taken over. But the basket was a continual feature of the portfolio until we recently sold out entirely.

Our sell decision was as quantitatively-driven as the earlier buy decisions. Net nets have been a fairly frequent occurrence in Japan over its 25-year bear market, but sometimes they were more prevalent, sometimes less so. We had a hunch that the more net nets available at any one point in time, the higher quality the basket would be and the better the subsequent returns. In early 2013, we did extensive back-testing of that theory. Sure enough, based on historical experience at least, at any point in time when you could find more than 20 net nets, subsequent returns over the following year were superior and more likely to be positive than when you could find less than 10.

With net nets becoming rarer in Japan recently as the Abenomics bull market raged, we reached the point where we needed to sell half the stocks in the basket anyway because they no longer traded below net working capital value. But the analytical back-testing suggested it was time to sell the lot, even though some remain statistical bargains.

Table 2: Japanese Net-nets

Company	Return	Co.	Return	Co.	Return
Roland	140%	Mitsumi	29%	Kaneshita	5%
Kitakei	83%	Satori	27%	Nichiwa	4%
Marufuji	62%	Takano	26%	Sanko	4%
Marubun	57%	Shinko	26%	Fujix	4%
Kawagishi	57%	Futaba	24%	Sakai	4%
Daiwa	53%	Ryoyo	22%	Nankai	2%
Tomen	44%	Sanyo	20%	Toa	2%
Hokuetsu	40%	Sanshin	18%	Mansei	-6%
Excel	40%	Uehara	8%	Funai	-6%
Sugimoto	38%	Hosiden	7%	Nagahori	-8%

It's been a good experience. As shown in Table 2, of the 30 stocks held anytime over the past two years, only 3 lost money. Ten delivered returns in excess of 30% and one of those, Roland Corp, gave total returns of 140%. The average return was close to 30% in local currency (Japanese yen) terms after brokerage on the fiddly trading. This underperformed the 55% return from the bellwether Nikkei 225 Net Total return Index over the same period, but that is unsurprising. The basket was expected to deliver positive medium-term returns in all but an Armageddon market, but not outperform blue chips in the raging bull market that ultimately transpired.

Despite ups and downs, the Australian dollar/Japanese yen exchange rate is little changed from when the portfolio was put together, and didn't materially add to or detract from returns.

While we own no more Japanese net nets today, we'll keep running the filter and look to purchase another basket should such statistical bargains become more numerous again.

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	31 December 2014
Buy Price	$1.4208
Redemption Price	$1.4095
Mid Price	$1.4151
Portfolio value	$58.3m

AUSTRALIAN FUND PERFORMANCE

The Australian Fund lost 3.4% in the December quarter and was soundly beaten by the 2.6% positive return of the benchmark All Ordinaries Accumulation Index. For the year the Australian Fund returned 2.2% versus 5% by the benchmark – not horrendous relative performance but not the type of results sought for the long term either.

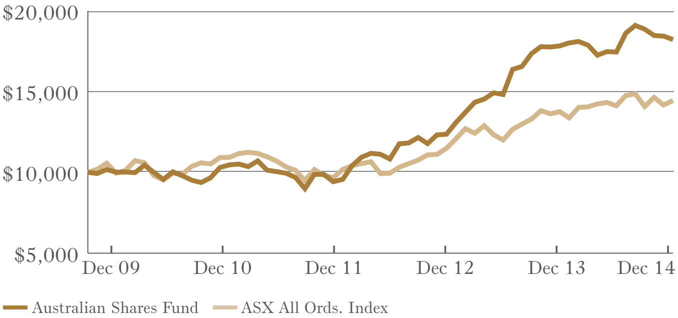
The Fund's record since inception, a decent measure of whether the Fund has served its purpose as an investment vehicle, looks better, leading the benchmark 12.3% per annum to 7.4%.

Table 1: Summary of returns as at 31 December 2014

	Australian Fund	ASX All Ords Accum. Index
1 month return	–1.15%	1.93%
3 month return	–3.39%	2.58%
6 month return	4.43%	2.28%
1 year return	2.21%	5.02%
2 year return (pa)	21.41%	12.10%
3 year return (pa)	24.59%	14.30%
Since inception* (pa)	12.31%	7.37%

*Inception 31 Oct 2009

Chart 1: Comparison of $10,000 invested in Australian Shares Fund vs ASX All Ordinaries Accum Index

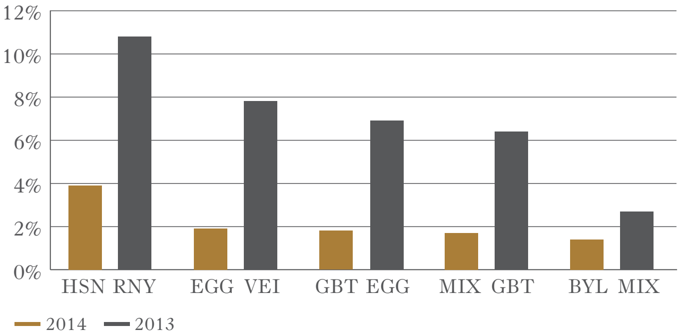


There are two reasons for the modest returns this year. Chart 2 provides the first answer, comparing the contribution of the best performing stocks to the Fund returns this year and last. You can see the contributions of the best performers last year tower over this year's best. Last year **RNY Property Trust** (RNY), for example, contributed more than 10% to the return of the *whole portfolio*. In a concentrated portfolio like the Australian Fund, big wins can really move the dial. And 2014 was essentially a year with no big wins.

The big wins that drive returns are a function of good stock-picking, patience and luck. They don't, of course, arrive with any type of consistency, and that is why lumpy results are to be expected (and have been experienced) with this Fund. There's nothing that was done so differently in 2014 as to 2013 to explain the huge difference in results. The factor most controllable, the stock-picking effort, went well in 2014 with a number of promising ideas added to the portfolio that should help future returns.

The other factor curtailing returns was our collection of new investments in the mining services sector. Combined, these investments lost the Fund around 6% of net asset value. That's unfortunate, it always is to lose your money, but it goes hand in glove with the investing strategy of the Fund – results vary and losses will be worn from time to time. (If it sounds too devastating, remember the Fund made 10.7% on its five best investments in 2014, a year notable for its *absence* of big wins. The share price of individual companies in the portfolio can fluctuate a lot year to year.)

Chart 2: Top 5 contributors to Australian Fund returns



Despite the heavy falls before the Fund bought, clearly we moved too early into mining services. That's only obvious in hindsight though. Low prices at the time more than factored in the bleak outlook, and the danger with waiting too long is you risk missing the opportunity. This certainly could have happened with other Fund investments like **GBST Holdings** (GBT), **Hansen Technologies** (HSN) and **Brierty** (BYL) which delivered gains immediately after being purchased.

It's impossible to know in advance how low prices will go. Other sharemarket investors look to the future too, and prices rally in anticipation of better times well before conditions improve on the ground.

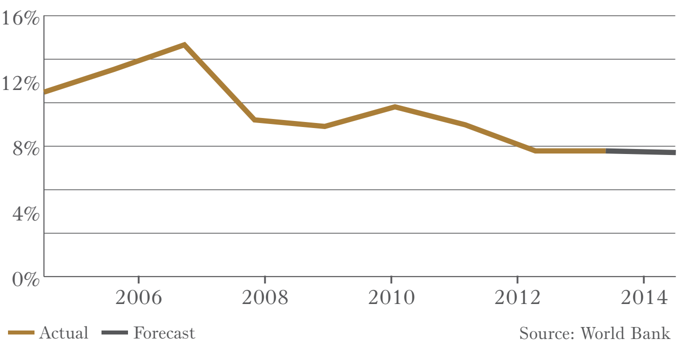
Though it would be nice to enter at the bottom and though the Fund is wearing early losses, further capitulation in mining services *helps* the Fund. This is because it improves the opportunity set in which to invest. Businesses like **Macmahon Holdings** (MAH) that were cheap are now even cheaper and the Fund has been able to top up. Long term that's ideal and mining services remains a prospective area.

In the December report last year we cited the risk of a slowdown in China and the need for currency diversification to shield from knock on effects to the Australian economy. Both themes have played out this year. Chinese growth has moderated, creating havoc for domestic iron ore producers who had bet China would grow 'stronger for longer', and the Australian dollar weakened 8.5% to US$0.82 in 2014.

"IN A CONCENTRATED PORTFOLIO LIKE THE AUSTRALIAN FUND, BIG WINS CAN REALLY MOVE THE DIAL. AND 2014 WAS ESSENTIALLY A YEAR WITH NO BIG WINS."

The Fund did nicely with its US dollar exposure through companies Hansen Technologies (HSN) and **Enero Group** (EGG), which derive significant portions of revenue outside Australia, and also from the now wound-up **Mirvac Industrial Trust**. But despite owning nothing but United States office property, the unit price of the Fund's largest investment RNY drifted around seemingly uninfluenced by currency or a strong US economy, up only 1.8% in 2014. That shouldn't trouble us unduly, value has increased in Australian dollars and the Fund will benefit eventually either through distributions or asset sales.

Chart 3: China GDP growth



JUMBO EYES JACKPOT ABROAD

Another stock which hindered returns in 2014 was **Jumbo Interactive** (JIN), an online-seller of lottery tickets. We haven't said much about this business while we slowly increased the Fund's holding, but with the share price down significantly and the Fund's holding up, it's another holding primed to provide good returns over the coming year.

Established online lotteries are generally fantastic businesses; costs are relatively fixed and players are flocking online in big numbers. A brief look at the share price chart suggests Jumbo has its problems, though. They start at home.

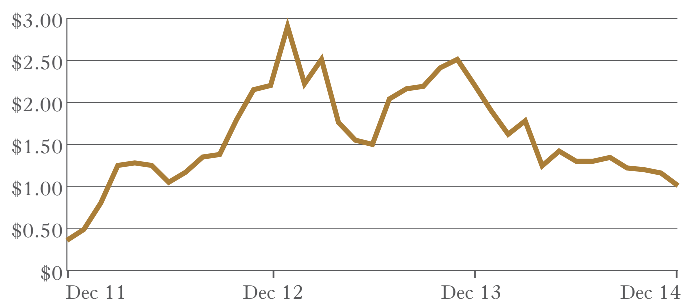
With a database of 1.7 million customers, Jumbo's established (and profitable) Australian business is the largest independent seller of lottery tickets in the country. Unfortunately, Jumbo doesn't run its own lotteries. It is merely an authorised retailer for **Tatts Group** (TTS), which has managed to buy itself a monopoly on lotteries in Australia.

Under new management, Tatts is focussing on its own website gaining customers rapidly. Jumbo has still been growing, but Tatts has been growing faster. In addition to this unwelcome competition, Tatts has declined to renew Jumbo's long-term resale agreements. That means that at any time Tatts wishes, it can pull the rug out from Jumbo's feet and cripple its Australian operations.

To reduce its dependence on Tatts, Jumbo has its eyes on riches in Germany, Mexico and the United States. Despite significant amounts of money spent, the only place where it is operational is Germany, and that isn't going well.

The battle to sign-up customers in Germany, where online lottery sales were recently legalised, is fierce between state lottery websites and private competitors. While its largest private competitor has been signing up 75,000 customers a quarter, Jumbo's sales have been so anaemic that Jumbo hasn't even been willing to disclose them. In the era of PR influenced and carefully crafted market announcements, you can safely assume everything you aren't told is bad.

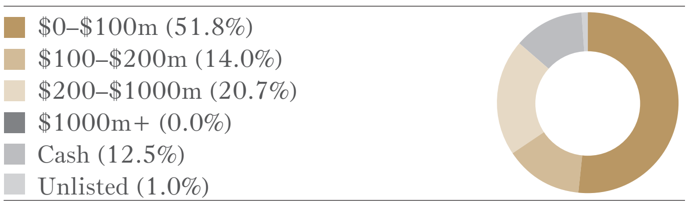
Chart 4: JIN stock price



It's early days and management are looking to differentiate the offering to players, but despite a fair chunk of money having being spent setting up in Germany, Jumbo looks to be holding a weak hand.

The market is rightly nervous about all of these issues and the share price has been hammered. To the point where we think it has become absurd.

Chart 5: Portfolio distribution according to market cap



The risk from Tatts is real, but the tiny market capitalisation of $45m now surely overstates it. Signing up new customers is painful due to anti-money laundering compliance. If Tatts were to terminate Jumbo's agreements, it will lose Jumbo's active lottery players for its trouble. Getting them back would be a headache and probably expensive. It is probably easier to simply buy Jumbo or retain the status quo.

> “SALES IN GERMANY HAVE BEEN SO ANAEMIC THAT JUMBO HASN’T EVEN BEEN WILLING TO DISCLOSE THEM. IN A PUBLIC RELATIONS ERA OF CAREFULLY CRAFTED MARKET ANNOUNCEMENTS, YOU CAN SAFELY ASSUME EVERYTHING YOU AREN’T TOLD IS BAD”

Jumbo has $16m of free cash, so investors are only paying $29m for the Australian business. Excluding marketing, website development, and international expansion expenses (real outlays, but discretionary and mostly made to improve future profitability), operating earnings last year were $13.9m before tax. There’s a good earnings stream if Tatts doesn’t squash it, and on top there is a chance the German or other international jurisdictions take off in a big way. At worst m anagement, with a big ownership interest in the company, should remember W.C. Fields’ advice: “If at first you don’t succeed, try, try again. Then quit. There’s no point in being a damn fool about it”.

That would leave a very valuable Australian business. Even if Tatts does move to shut down the Australian business, all is not lost. Jumbo retains ownership of the customer database, which has significant potential marketing value to other online gaming and betting websites (another reason Tatts should keep Jumbo within the fold), the free cash and international operations. With the downside less than catastrophic and some chance of hitting the proverbial jackpot offshore, it’s a nice addition to the Fund portfolio.

Table 2: Summary of major investments

Stock	Portfolio Weighting
RNY Property Trust	15.3%
Hansen Technologies	8.7%
GBST Holdings	6.9%
Service Stream	6.5%
Vision Eye Institute	5.9%

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