Suite 11.02
Level 11
37 Bligh St
Sydney 2000
NSW

Harness Asset Management Investment Report June 2015

Dear Investor,

Welcome to the Harness Asset Management June 2015 update.

The recent half has been interesting as the market really moved from a cautious bull trend to an out and out bull market which led to a top and then a pretty savage correction, as fear emerged again. There has been an enormous amount of new listings and perhaps even more capital raisings by existing listed companies. I found myself saying many times, "*you could float a brick in this market*".

The broader market moved higher until late April fuelled by what appears to be, the ongoing pursuit of yield. As often happens, the market got stretched and started to correct in early May falling about 10% by the end of June. Many stocks including the banks, Slater and Gordon and Woolworths fell much more. This reinforced to us again that even owning so-called blue chips is no guarantee of success if you pay too much.

We have found the recent environment difficult to find compelling opportunities to invest in but remain patient with a long-term view. Our focus is to provide positive returns over the long run and we don't benchmark to indices, as we believe this will drive an average performance and lead to big capital losses when markets turn downward. Our value approach is designed to out perform a weak market and it is worth noting that during the recent circa 10% pull back in the broader market, our fund moved down about 2%.

Performance of founder's units to 30 June 2015:

Period	Fund	ASX 300 Accumulation
1 Month	-0.30%	-5.32%
3 Months	-1.72%	-6.47%
6 Months	2.87%	3.17%
Since inception (Nov 2014)	4.75% p/a	2.79% p/a
Size of fund	$10.2m	

Below is a chart of the All Ords - a simple graphic of a pretty volatile year.

Source: Big Charts

Berkshire Hathaway Visit

It is pretty amazing to see two investors, one in his mid 80s and the other in his early 90s talking about the 100-year outlook for their company. This is the sort of discipline and focus that has helped make Berkshire Hathaway such an amazing company.

I attended the AGM in Omaha again this year to have investment principles reinforced, catch up with other investors and attend the value investor conference held before the AGM. As always, it was educational and re-energising. The attendance was around 45,000 so this year may be my last. The crowds are pretty crazy, so being a contrarian by nature I don't much like crowds.

Warren and Charlie are wonderful, still sharp and witty as ever. I doubt the world will ever see a combination like that again. It has been a privilege attending the AGM several times.

Market Outlook

Recently I attended a Macquarie Bank investment conference. It was well attended by fund managers and high net worth investors. There was a large number of small, medium and large companies presenting over the three days.

A few interesting observations came out of the event, the "in favour" growth type stocks had standing room only (investors searching for confirmation bias?), indicating to me that many stocks are well owned and probably fair to over valued. Some of the "out of favour" stocks (of which there were very few) had attendance numbers of perhaps 20% of the more favoured stocks and these were the ones we have tried to do more work on. Secondly, I became aware (not for the first time) that despite the importance of experience in the art of investing, there were few attendees over 40 years old and even fewer that worked in the market during the last real recession Australia experienced in the 1990s…am I really that old?

I spoke to as many of the more experienced investors as I could and I can honestly say that not one provided an investment idea that they believed was compelling value. This was interesting, and was timed perfectly before the recent correction.

The wash up and reminder for me was to stick to what we do and don't get caught up trying to predict short-term market moves. Value will have us investing when there are good opportunities and selling when stocks are expensive. We will not accurately pick market tops or bottoms unless we get lucky. We will stick to our principles; preserve capital, take a long-term approach and exploit attractive risk/reward situations. Geoff Wilson is one of the wisest investors in the market and bumping into Geoff is always a valuable experience. He was counting the attendees at each presentation and like me, gauging market sentiment on specific stocks. He said to me a couple of times, "*Nige, you gotta play the long game*". Wise words at a time when good value is hard to find.

Portfolio

At year-end, our portfolio is holding about 24% cash (and cash equivalents) and 31 stocks. We took advantage of a small number of trading opportunities during the period which helped make up for a few of our value stocks which have not performed well. Their fundamentals remain intact but the market is just not interested in these low-risk, asset style plays at this time. Below I have gone into a little more detail of some of our holdings.

In the past year we visited 100 or so companies in Sydney, Newcastle, Melbourne, Adelaide, Brisbane and Kuala Lumpur. Meeting management is a critical component of the investment process. We aim to learn as much as we can about how companies operate but equally we try to assess the capability, drive and vision of management.

Amongst the 31 companies we own there is a blend of deep value asset plays, growing small caps with exciting prospects and under-priced income stocks. One is paying us a very dependable 11.5% fully franked dividend yield.

What Do We Own?

Shane Finemore is one of the better market operators around and an old friend of mine. His response to my last market update was "*You need to include some of the stocks you own or no one will read it.*" Fair enough mate!

FSA Group (ASX: FSA)

For those who have taken the time to read our Pineapple investing strategy (on the website), you may recognise FSA as an ideal Pineapple.

Back in 2010 FSA shares had fallen from a high of around $1 to lows in the 30-40c range. It had been sold off for a few reasons that I didn't agree with, the management team who also founded the company owned a substantial stake and had proved themselves to be very competent and I believed, honest. The underlying business was of good quality enjoying return on equity of high teens and moving higher. AND most importantly it was very cheap, trading at a discount to NTA and P/E of about 3-4x. Its cash flow was constrained due to a change in the way FSA got paid for its services but it was temporary.

To summarise: it was cheap, had good management, had a good business and **I disagreed with how the market was valuing the shares.**

I bought about 3% of the company representing a substantial share of my portfolio at the time and then had to stomach some lower prices before the share price ultimately recovered. This recovery was partly triggered by the company's decision to start buying back shares. Ultimately it bought back around 10% of

issued shares and started paying healthy dividends. Over the next few years the shares rallied to a high of over $1.50 in 2014 and is now trading at $1.25.
While the stock is not as cheap as it once was, it is now trading on a P/E around 10x 2016 earnings with a dividend yield of 5% fully franked, its earnings continue to grow and are quite counter cyclical given its in bankruptcy services. I would consider its valuation fair. Higher interest rates should be good for earnings and it has an exciting new growth product that provides budgeting services to clients. This service is growing strongly and has the capacity to contribute significantly in future years.
FSA remains our single largest investment due to its sound business, good management, undemanding valuation and potential growth.

PMP (ASX: PMP)
This stock was another I purchased before the establishment of HAM and chose to bring it into the Fund due to its very low valuation. It started 2015 at 43c and finished in June at 53c. Most of that increase happened in the last month. The position has tested our patience this year but we have persevered with our holding due to good management and low valuation. PMP is primarily a catalogue printing business with large clients such as Woolworths. It has had a very poor corporate history plagued by a series of managers who tried to combat the lack of organic growth of the business with a series of poorly considered acquisitions leading to higher debt while the core business was deteriorating due to industry over capacity and structural change. The current CEO has focussed on cost cutting and debt repayment and has rescued the business from potential failure at the hands of the banks. The focus is now on maximising free cash, retiring all debt and ultimately giving cash back to shareholders.

The stock is trading at less than 5x free cash flow. In the event this cash was used to pay dividends, the yield would be 20% but let's not get ahead of ourselves as, there is still some water to go under the bridge before that can happen. The company should be net debt free within the next 6 or so months.
The risk is that things deteriorate at a faster rate and there is very little left for shareholders once the debt is paid down to zero. We have taken the view that catalogues remain an important part of retail marketing in Australia and will continue to be used for years to come and dividends and buybacks will repay our patience. We also have a free upside option on industry consolidation. A merger within the industry would most likely be good for all players.
To summarise: PMP possesses good management, a compelling valuation, and an OK business with significant potential upside from possible industry consolidation.

United Overseas Australia (ASX: UOS)
UOS was the feature of a longer article we sent out a couple of weeks ago and which is posted on our website. http://harnessam.com.au/wp-content/uploads/2015/06/united-overseas-australia-july-2015.pdf
It is an exceptionally well-run property developer based in Kuala Lumpur yet listed in Australia.
It has been listed in Australia since 1988 and has compounded its net tangible assets at about 20% p.a over that time, an exceptional result in anyone's

language. The stock trades at about half our assessed net tangible assets per share, has close to no debt and a large amount of net cash.
To summarise: UOS boasts a compelling valuation, very good management, a good business with a very long positive track record and is largely unknown in the Australian market.

Stream Group (ASX: SGO)
This micro cap only came to market in April 2014 and has performed poorly since dropping by 50% before we started building a position and then increasing it in a recent rights issue.
SGO provides services to the insurance industry. Many insurance companies outsource the process of claims management and that is the primary role that SGO plays. The company has operations in Australia, New Zealand and the UK. The last 18 months or so have been challenging for the company but we feel the odds favour us making money from our entry point.
We have got to know management in over a dozen meetings and can see significant potential upside. Most likely we have seen the risk reduced significantly over the last year.
To summarise: SGO appears to have good management, an OK business; it has good growth prospects and is cheap if management can continue to deliver.
SGO is not a large position for us but it has good potential upside and we may increase our position as the business matures.

Moving Offices
After a couple of good years on Macquarie Street we have been forced to move. We have taken up digs at Suite 11.02. Level 11, 37 Bligh St, sharing with two other boutique fund managers.

Please call me if you would like to discuss further.

Good investing,

Nigel Littlewood
Ph 0414585070

Note: Harness Asset Management Small Companies Value Fund (the Fund) own shares in the stocks mentioned above as at 30 June 2015. The above is in no way intended as financial advice, nor any recommendation by the manager of the fund.

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