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Harness Asset Management Investment Report Mar 2016

Dear Investor,

Welcome to the Harness Asset Management Mar 2016 update.

What a world we live in! Last year several of Australia's well run hedge funds had excellent returns with much of this return provided by large short positions in mining and mining related stocks. After such a stellar year many of these hedge funds saw good inflows as investors flocked to last year's good performance. No sooner had this happened than the short trade got too crowded and a short covering rally was triggered which appeared to wipe out quite a bit of last year's profits. As we learn't from our own portfolio last year, so often the star one year is the dog the next…this is just the nature of cycles. One is usually better served by investing in last year's dog than last year's star…of course there are always exceptions.

Last week, Ireland sold 100year, 100m Euro worth of bonds at a yield of 2.35%, this followed Mexico's 100 year bond for 1.5bn Euro at 4.2%. Would you lend money to the Irish Government for 100 years at a yield of 2.35%? or any other government for that matter? Central banks continue to maintain interest rates at crisis levels, nearly 10 years after the GFC while most major governments keep running budget deficits. With the levels of Government (and other) debt in the world, I think it is only a mater of time before creditors start to pay the price for poor lending practices. How this happens, I don't know but monetisation of government debt must now start to look like a real possibility. Countries like the USA, Japan, Greece, UK and Italy all have Government debt above 100% of GDP and getting bigger. There are only three solutions to balancing a government budget: higher taxes, lower spending, or printing money to fund expenses. Only one of these appears politically palatable but it will have serious consequences if the general rules of economics still apply. From Nazi Germany to Zimbabwe and Argentina, printing your way out of financial stress has not worked and I doubt it will work now. We must maintain vigilance in this dangerous time and maintain our prime focus of preserving capital…I must stress that avoiding equity-like volatility is not part of the objective, volatility I accept. I focus on the risk of permanent failure in the underlying stock when considering risk.

As we finish the first quarter of calendar 2016, the ASX 300 accumulation index is down about 2.6% while the All Ords is down (excluding dividends) around 6% for the financial year and 4% for the quarter. The primary reason for this weakness is a lack of growth amongst both the large stocks in the market and the broader population of listed companies. The stocks that are growing strongly such as Domino's, Bellamys, Corporate Travel and CSL are trading on very high multiples. The following drivers appear set to continue in the short term and remain a hand-brake on the market moving significantly higher:

1) Broad growth is anaemic
2) Productivity gains are very hard to achieve and often lead to deflation pressures.
3) Economic reform is stagnant due to politician's unwillingness or inability to tackle the issue.
4) The AUD has remained stubbornly high.
5) Business is not investing much outside technology.

In the last month or so we have seen strong rallies in many of the mining stocks (and underlying commodities). My sense is that this was largely technical. That is, that the short trade just got too crowded and prices spiked as short sellers rushed to cover positions. (in market speak *it got oversold*) Given that, I would not be surprised if we have seen the lows in commodities now and that the bear trend has ended. Much like the rest of the market, we appear set to continue to grind sideways in a predominantly range bound environment for the time being.

Having said all of that, I remain confident of finding a small number of really exciting opportunities a few times a year. The great skill in this business is knowing when to do nothing with the portfolio (most of the time) but knowing when to explode into action. Perhaps more than any other profession, this business looks much easier than it is, to the inexperienced.

While our historical performance below looks somewhat similar to the market, it has the capacity in its constituency to provide us with good returns regardless of the broader market movements. We are holding cash and cash equivalents of about 27% and remain very happy with the companies we own and have provided more details below on some of those.

Performance of founder's units to 31 Apr 2016:

Period	*Fund	ASX 300 Accumulation
1 Month	2.4%	4.77
3 Months	-2.4%	-2.6
6 Months	-2.7%	-3.7
1 Year	-6.5%	-9.2
Since inception (Nov 2014) p/a	-1.06%	-0.95
Size of fund	$10m	

*Assumes reinvestment of distributions.

Our portfolio

Reporting season is a frantic time for investors. In February, half yearly results are provided and we all run around trying to garner as much insight as possible. In previous years, I ran myself ragged seeing as many companies as possible. The benefit of this exhaustive pursuit was difficult to measure unless you value the currency of busyness. This year I tried a different approach and attended far fewer meetings, instead narrowing my focus. On balance a better approach I think and one that allowed me more time to think.

Our companies reported unsurprising results. **RFP (listed on the NSX)** reported another solid set of numbers and our very handy dividends keep flowing in each quarter. **We are enjoying a pre tax yield exceeding 18%** based on our original entry and the stock continues to trade at a discount to its NTA. We remain happy holders.

PMP has been a significant investment for us since launching the fund in 2014. It has been a volatile and often frustrating exercise. The market's appetite for low growth value-type stocks has been largely absent. Despite management doing a great job of running this business hard in challenging conditions, the share price is down slightly since the start of the financial year. Having said that, it has been quite volatile. It closed the last quarter out at 51c after hitting 56c before plumbing crazy lows of 42c then bouncing straight back into the 50s. Another reminder of the extreme volatility that stock prices undergo relative to the underlying business.
In the last 9 months PMP has rallied 27% before falling back 25% then rallying back over 24% in a matter of weeks. WOW no wonder equity investing can be so scary for those who don't really understand what they own. During this time the outlook for the business didn't change.
The best solution to the understandable fear and greed that one may feel in response to this volatility is having a realistic understanding of the underlying asset or business and a firm view of its approximate fair value.
This volatility serves to remind us that there are trading opportunities in stocks we understand and I intend to exploit these opportunities more pro actively.
PMP remains a material investment for us (despite having sold some) as our confidence continues to grow that an industry consolidation deal is not only compelling logic but commercially unavoidable. **Substantial value should be created by sensible industry consolidation.**

FSA remains our largest position and delivered an unexciting result but our long-term confidence remains. Australian's are geared to the eyeballs and at some point the odds favour this to result in increased levels of financial stress. FSA is well positioned to help in this situation via its services division. On top of that, FSA has invested in growth in its loan pools which are growing but the investment in growth has resulted in higher costs so has not led to an increase in profit yet. We expect to see earnings start to increase next year due to the larger loan pools. While we wait, **we receive a 6.5% fully franked yield**. The senior management team is smart, honest, sensible and owns a lot of stock so the structural incentivisation is right.
Value investing does require patience. This stock has cost us in the short-term but its long-term outlook hasn't changed.
The link below will provide more info on this one.
http://harnessam.com.au/wp-content/uploads/2016/01/Drowning-in-a-mountain-of-debt.pdf

One of our more exciting investments is a very old style *boring* business that makes shade cloth…yes the shade cloth you see across car-ports and kids playgrounds. **Gale Pacific (GAP)** is a world leader in the design and manufacture of this stuff (amongst other products). It's sold around the world and **the markets of the Middle East and USA are growing strongly as people outside of Australia and NZ realise that protecting kids (and ourselves) from the sun is important.** There is good growth in this business yet we are buying the stock on a single digit p/e. The balance sheet is sound, management is doing a good job and as yet the broader investment community has not discovered it.

We remain happy holders and look forward to growth surprising the market in the year or two ahead.

Aquarius Platinum (AQP) was an arbitrage we entered into back in October and December. It was subject to a merger proposal with US$ payment of US19.5c per share. We bought the stock at 23c and 24.5c with what appeared to be a very nice outlook due to an exit price that looked like being up above AUD27c. Unfortunately, the C10% rally in the AUD has reduced our profit. Despite this, we will realise a profit this month of about 8% or an IRR of over 20% but despite this it is a reminder that currency markets are volatile and unpredictable.
This sale will boost our cash position again.

Clydesdale Bank (CYB)
In 1987 during the glory days of National Australia Bank and its market leading position, it made the strange decision to buy Clydesdale Bank from the far better informed Midland bank. It then proved over a long period of time it did not have the capacity to run its UK investments well. The recent sale process will result in a substantial write down. I'm not sure exactly what that will be at this point but it appears the decision to buy Clydesdale cost NAB shareholder billions.
I have watched many subsidiaries flourish once freed from huge bureaucratic ownership. Look at Telstra, Medibank Private and Asciano as examples.
CYBG as it is now known on the market, has high costs and low return on equity. It has a large legacy issue that it is working through that will cost the business up to 1 billion pounds (fully provisioned for) but is well explained to the market. It has a new management team with a sound track record and the motivation to drive costs down and grow the mortgage book. Due to it low return on equity the stock is trading at 0.6 of book making it appear very cheap but shareholders will only get rewarded if ROE improves.
I have taken the view that management will be aggressive in its pursuit of efficiency, cost cutting and productivity. The anecdotal feedback I have about the UK banking industry is that it is ripe for significant consolidation as scale is so important. Where CYBG fits in this process I don't know but it is a free option on the upside.
This is a solid asset that despite NABs' best (worst) efforts, has survived and appears to have a good brand and is trying to rebuild loyalty and customer sentiment. It's cheap and I believe the odds favour shareholders with a medium to long-term view, being rewarded for buying today.

We are now sitting on 30 stocks and 27% cash, which is more than I would like but mistakes can be costly so we will wait for compelling opportunities. During this process we may underperform the market for a period of time but we will prioritise preservation of capital and be ready when we identify attractive risk/reward situations.

Please call me if you would like to discuss further.

Good investing,
Nigel Littlewood
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Note: Harness Asset Management Small Companies Value Fund (the Fund) own shares in the stocks mentioned above as at 31 Mar 2016. The above is in no way intended as financial advice, nor any recommendation by the manager of the fund.

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