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Harness Asset Management Investment Report Jun 2016

Dear Investor,
Another financial year under the bridge and as we enter the 2017 Financial Year, I am excited about the value in our portfolio. **We own shares in a collection of well-run businesses at attractive valuations, the fund is receiving a solid dividend income and we have cash for compelling opportunities. Bring on 2017.**

The primary reason for our performance not delivering as expected, was that our cash position averaging over 20% through the year, contributed little to performance and our two biggest positions were negative contributors. FSA fell over 25% due to a lack of short-term growth costing the fund about 5% and Arowana (ASX:AWN) fell about 40% costing us another 5%.
So often in the market, last year's under-performer is the next year's star. We remain positive on the prospects for both AWN and FSA for the future.
At the time of writing our cash position is about 18% of the portfolio and we own 25 stocks.
Brexit was a surprise to many. We had incorrectly backed the conservative English to vote to stay in the EU. Clearly, we misjudged the anti-establishment mood in the UK. I suspect that many who voted "OUT" were really just sending a big "up yours" to politicians, bureaucrats and big business. There appears to be a major mood trend amongst people of the western middle class who are gradually doing it tougher and tougher at the expense of emerging markets. After all, we live in a global where an educated professional living in (say) Mumbai and with equivalent skills to those living in London or Sydney may well be competing for the same job. There is currently a big differential in salaries between those markets, and this gap is shrinking**. The Western middle and working classes can feel it and are frustrated and frightened. The environment is ripe for more political populism and resistance to globalisation.**
The collapse in UK orientated banking stocks was breath taking bringing back memories of the GFC. Banks fell between 30% and 50%. We had a position in Clydesdale bank, which we sold for a small profit. The trade had gone from a relatively predictable "cost-out" scenario to one with significant political and economic uncertainty. We spoke to a trusted source on the ground in London and took the view that the risk of a property collapse and/or prolonged period of political logjam was too high for us to maintain exposure to. **The one thing that the investment business is never short of is reminding us that risk often comes from unpredictable directions.** In future we will consider insurance in a similar situation…or simply avoid the situation if possible. (What would a Donald Trump victory do to markets?)

We remain of the view that Australia is likely to see lower interest rates and a weaker currency in the year ahead. Other trends such as those below will most likely continue:
Ageing populations in Australia, China, Japan and others.
The emergence of Electric and self-driving cars.
Stand-alone solar and wind power generation systems with battery capacity.
Health and well being products and services, cosmetic surgery.
Automation of processes and off shoring of others.
Digitisation of just about anything and ongoing of collaborative consumption.
Demise of traditional business models such as banking, media and insurance.
#Chinese tourism.
Of course, the list goes on but we remain vigilant of the underlying trends in the businesses we own and therefore, try to invest in such a way that those trends represent tail winds not head winds. Having said that, often the market over prices stocks with tail winds and attractive value is found in more obscure areas of the market. In the case of PMP we have profited while investing against the industry trend.
We continue to hunt where others have chosen to ignore.

Performance of founder's units to 30 June 2016:

Period	*Fund	ASX 300 Accumulation
1 Month %	-1.77	-2.44
3 Months %	3.2	3.98
6 Months %	0.78	1.23
1 Year %	-1.65	.98
Since inception (Nov 2014) p/a	1.7	2.2
Size of fund	$10m	

*Assumes reinvestment of distributions.

Some of our positions are updated below.
FSA Group

Chart from Yahoo

In the last quarter FSA reported the sale of its factoring business. We are happy with this decision, it was not a natural fit in a group, which, primarily focuses on helping individuals with debt problems. The Factoring division had a different client base and risk profile.

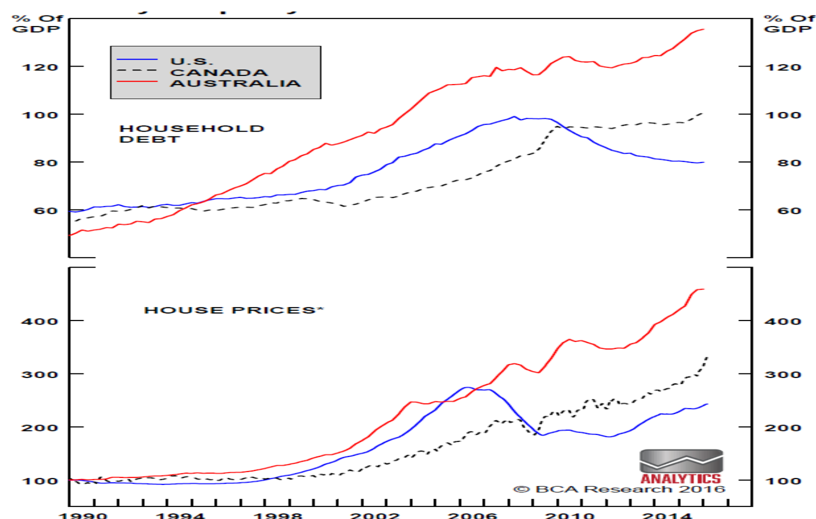
FSA has boosted its cash coffers by around $10m and is therefore pregnant with potential. It has been investing in its loan pools, which should deliver growth in 2017. The services division remains stable, however, if you look at the chart below you will see the evidence of Australian's participation in the mother of all booms. Australia's residential property market has been in an upward trend since interest rates started to fall 25 years ago. That's an almost uninterrupted 25year bull market in most places (mining towns aside) leaving city residential property the most unaffordable in the world. Is there a chance that we end up as a nation of renters like many other countries in the world? I guess most people are, they just rent from a bank via their mortgage.

As you can see below, household debt keeps climbing as a percentage of GDP and Australia is leading the world. While US consumers have deleveraged through the GFC, Aussies have kept borrowing and driving property prices higher.

I don't know how this ends but **every boom busts**. **This will end at some point and there will be a great number of people finding themselves in financial distress requiring the services of FSA** to restructure their debt position.

We are starting to see the media articles about off the plan apartments selling at material discounts (at completion) to the price buyers paid only a few years ago. In some markets there will be a significant over supply and much weaker prices. Of course, this wont be the same for every area and every property but it should filter through and deflate this crazy market…at some stage.

FSA is our largest position in the fund and has hurt our short-term performance falling 38% since peaking last August at about $1.60. The fall has cost the fund around 6%. Despite this, the fundamentals are sound, management is strong, value is attractive at about 10x 2016 earnings and paying us a 6.5% franked dividend. **Management owns around 40% of the company and maintains a long-term growth strategy, which, should see the stock double in the next 3-4 years if they get it right.** The excess cash and franking position provides the flexibility for capital management.



Money 3 (ASX:MNY)

chart from yahoo

Like FSA, Cash Converters and indeed the banks, MNY is out of favour.
During the last quarter after many management meetings, we bought a small position in non-conforming lender Money 3 (ASX:MNY). This $160m cap (at $1.04) company has seen its shares fall by over 40% in the last year because of its participation in the payday lending space. **This is the asbestos of the finance industry in terms of sentiment.** The industry has seen a huge social and corporate backlash fuelled by consumer advocates and the media. Regulatory costs have increased over the last few years as new compliance regimes have been introduced to try and protect short-term borrowers from unscrupulous lenders. Due to media scrutiny Westpac withdrew its support for MNY both as a wholesale lender and provider of transactional banking services. The other major player, Cash Converters also had to procure new funding sources when Westpac withdrew its funding.
So we have a sector that is highly profitable and growing but very much out of favour. Despite the negativity surrounding the space, I believe this sector will survive albeit in a more regulated fashion. It is highly profitable and customers keep coming back for its services. Both MNY and CCV have found new sources of funding and MNY has new transactional banking facilities in place.
MNY also saw board turmoil as conflict erupted over its future direction. During this period of tumult, the well-respected CEO of AMA Group, Ray Malone bought a substantial stake in MNY with his own money and assumed the role of chairman. He then set about fixing what needed to be fixed both at board level and in operations. It appears he has done a good job and has been very hands on giving presentations with the CEO, Scott Baldwin and visiting shareholders.
While around 15% of the MNY loan book is short-term payday style loans, most loans are secured car loans. MNY lends money to people requiring a cheap reliable car and default rates are surprisingly low. Some car loans are originated internally while others come via car dealers and brokers.

We purchased MNY at around 6 times earnings. In the event that the regulatory environment stabilises and market sentiment normalises, I expect the odds favour us seeing even better investment returns than we have had so far.
Risk is provided (as always) by a big increase in default rates or a significant change in the competitive arena both of which appear partly priced in. The risk/reward scenario looks worthy of our capital at this time.

Credit Corp (ASX:CCP)

Chart from yahoo

For those unfamiliar with CCP, it is a simple business but very well run. Good execution in this field is critical. CCP uses capital (a combination of both debt and equity) to buy PDLs (purchased debt ledgers). These PDLs are pools of non-performing loans that are usually provided by banks. Once these loans get to a certain point of delinquency, the banks simply sell them off. CCP buys them at a price and attempts to get back about twice what they pay for them. Sounds simple but there is a lot of intellectual capital and management discipline in this business. CCP is the market leader in Australia and has spent the last 4 years establishing a market position in the USA. On top of this, CCP provides small, medium-term loans to consumers via their own online origination channels.
CCP has actually been an acceptable performer in 2016 tracking the market for no net gain or loss. While it did experience a major correction early in the 2016 financial year falling over 30%, it has since been recovering. While we missed buying at lower levels we have acquired stock more recently post an update to the market in June suggesting the market is being too conservative in its expectations for 2017. While the market is expecting eps growth in 2017 of around 10%, we expect the company to do better.
We expect the US business to become profitable in 2017, which has huge potential in the years ahead.
The supply of attractively priced PDLs in Australia has increased and we have seen CCP buying up large amounts, underpinning growth in 2017.
On top of that, CCP's relatively juvenile lending business is growing aggressively and will continue to grow and improve returns on invested capital.

If we are right and CCP grows strongly, the current 10x earnings is too cheap. A PEG (PE/Growth) ratio of less than 1 is what we are looking for and this one comes in around 0.5. Management is sound, with a good track record of disciplined and opportunistic capital allocation for nearly 10 years. Again, the risk/reward looks attractive and worthy of deploying capital.

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 30 Jun 2016. The above is in no way intended as financial advice, nor any recommendation by the manager of the fund.

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