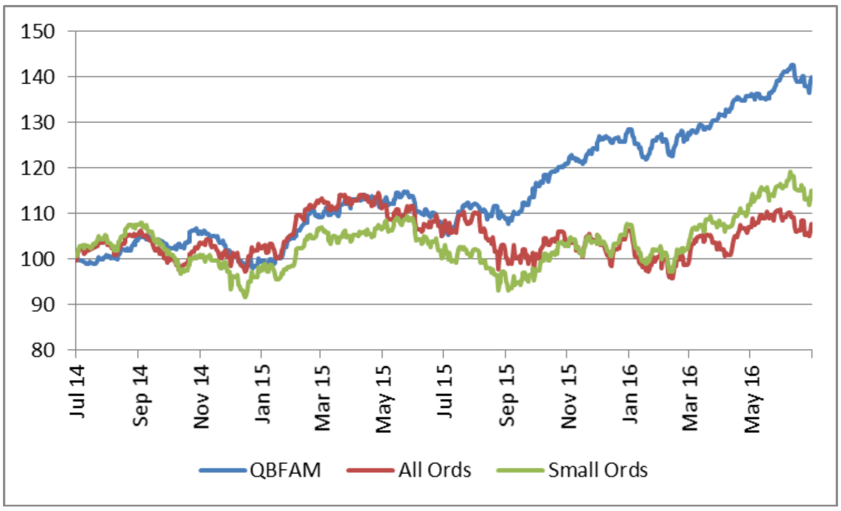
Quick Brown Fox Asset Management

Monthly Report – June 2016

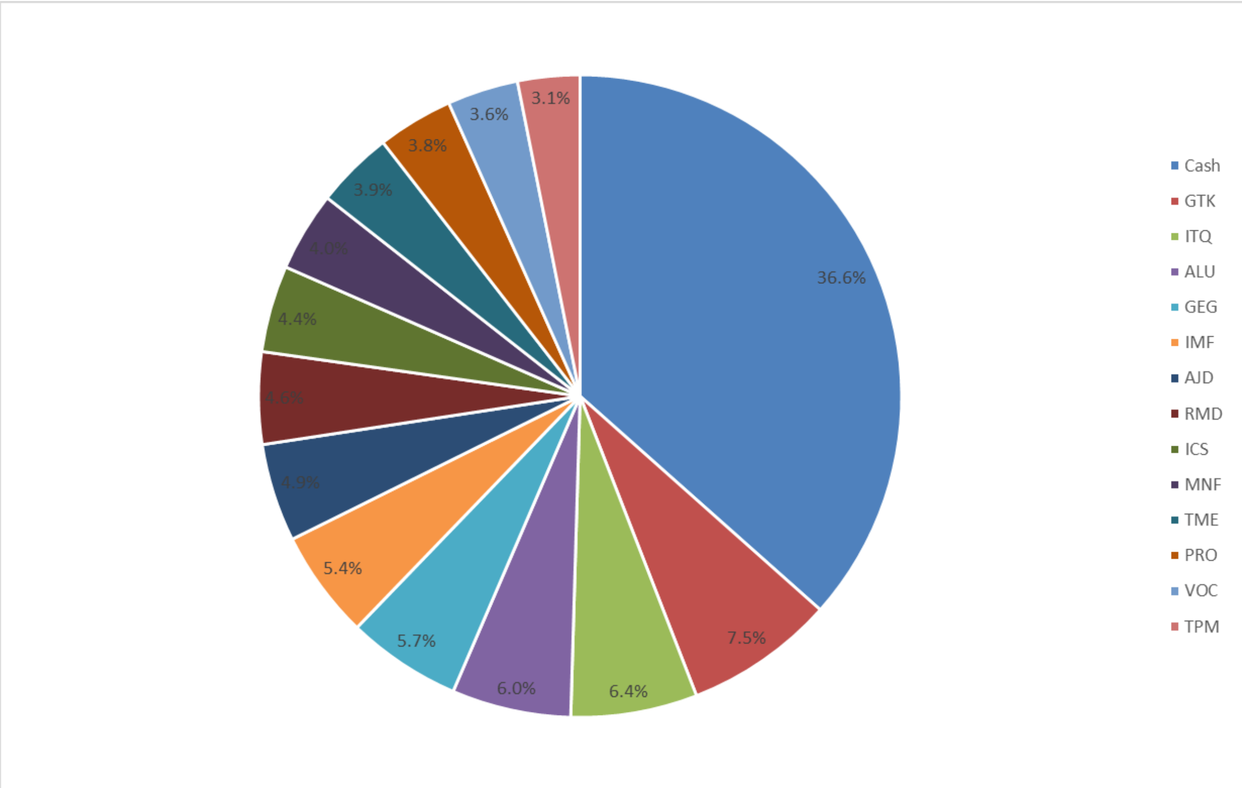
Global markets received a shock in June with the UK voting to leave the European Union. Panic selling hit markets led by dramatic falls in UK and European banks before a dramatic recovery. Whilst the "Brexit" vote acted as a catalyst for the original selloff, it is far from the cause of the recent volatility. We would argue the far greater concern sits within the European banking system which remains over leveraged and faces the structural headwinds of ageing populations and deleveraging. The fund outperformed during the month helped by elevated cash levels. We have increased our cash levels over the last 13 months from around 15% to 37% today. We didn't increase cash levels because we had a crystal ball and could predict the impact of a Brexit on global markets. Instead we increased cash levels because the quality companies we are interested in owning had seen their valuations move higher and the sectors where one could potentially find value face structural (not cyclical) challenges.

	1 month	3 months	6 months	1 year	Since Inception
					1-Jul-14
QBFAM	0.10%	6.04%	8.88%	32.79%	40.10%
XAOAI	-2.28%	4.00%	1.55%	2.00%	7.79%
XSOAI	-1.31%	5.85%	6.94%	14.40%	14.91%



The Portfolio

The fund is currently invested in 13 positions and retains a cash balance of 36.6% (up from 33% last month). The cash balance is up from 33% at the end of May. We reduced our positions in ALU and TME further during the month. We also completely sold out of HSN which had been a strong performer for us.



This month marks the 2 year anniversary of the Quick Brown Fox project. To mark the occasion we thought we would take a different tact with our monthly report and run through the background of the fund as well as what has and hasn't worked over its short existence.

<u>What is this all about?</u>

Two years ago I took control of my own superannuation. The reasons behind this were numerous with the core one being a belief that I could achieve greater returns than any alternative. This belief was backed by an extensive knowledge of the superannuation industry, which is one built on the foundations of regulated FUM growth, excessive layers of fees and over-diversification of portfolios.

Compulsory superannuation in Australia is a great thing, it forces people to save for their retirement, takes some strain off public resources and ultimately reduces future uncertainty. Unfortunately the success of the system has flowed through to an industry that has grown fat and lazy on high fees, subpar returns and easy profits.

Ultimately the portfolios constructed by Superannuation funds are "risk adverse" in that they will not differ dramatically from underlying benchmarks. This means performance can be explained by "It's what the market did". They then fall back on the principle that "Asset Allocation drives returns" which is usually backed up by incorrectly used citation of multiple academic papers. The correct interpretation of this research is that Asset Allocation will explain somewhere in the vicinity of 80-90% of the variability of a portfolio not the returns themselves. They will then tell you that volatility equals risk, a notion that implies a 10% increase in the value of the portfolio is an equal to a 10% fall in terms of risk. This is quite clearly not true. Risk should be explicitly focused on the downside and on capital preservation.

The whole industry is built around avoiding relative risks. The flow of capital is controlled by the large super funds and they allocate to fund managers to give them specific exposures. Those managers will have restricted mandates and limited flexibility. The average investor in the superfund will pay their fees to the superfund and then to these underlying managers for average at best returns.

Whilst I'm not a fan of the above investment approach it does make sense when you manage many billions of dollars. Currently the top 20 super funds in Australia manage $794bn. When you get that large, you have to have to invest in the most liquid assets and the ability of trading in and out of securities when they are over or under valued becomes compromised. As a result you are constrained by benchmarks and have to invest accordingly.

Individual investors are not constrained in the same way as the larger funds. They have flexibility in what they invest in. This opens up the investment universe and provides the ability to invest meaningful positions in smaller investments. It also gives the opportunity to take advantage of volatility in listed investments. These advantages should be a great incentive for investors to take control of their own superannuation and to allocate to smaller, more nimble, non-benchmark orientated fund managers.

On top of all this, return expectations for widely used benchmarks should be lower now than at any point in recent history. Interest rates remain at or near zero percent globally with inflation and economic growth subdued. The theory of secular stagnation made famous by Larry Summers goes a long way to explain this phenomenon. Essentially Growth, Inflation and hence interest rates have been declining for over thirty years with the major drivers being demographics (Aging population), deleveraging (the cost of debt levels being too high), wealth transfer (the rich getting richer and the poor getting poorer), and technological advance.

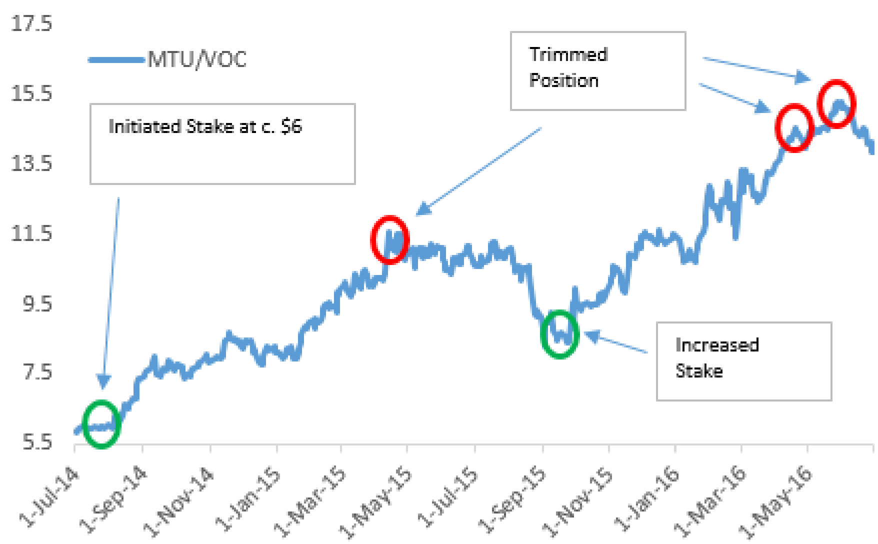
Low growth, inflation and interest rates lead to low expected returns across all asset classes. Traditional strategies based around asset allocation will no longer be able to achieve the 7%+ type returns of the past and will have to settle for lower. For an investor hoping to build a wealth base this is not good news. Consider also that whilst returns are lower, fees are not, the investment industry will therefore take an increasing share of the profit going forward.

<u>What worked well?</u>

Two years in and we are pleased with the returns. Obviously some things have gone right. Key contributors for the fund have been:

- M2 Group / Vocus
- Hansen Technologies
- Webjet
- Trade Me
- Intecq
- Altium

M2 Group / Vocus



M2 was one of the first investments we made after establishing the fund; we were attracted by the company's history of earnings growth and management's success in integrating acquisitions (as well as the outlook for the Telco sector). When we purchased the stock in July 2015, the share price had gone nowhere since their acquisition of Dodo in 2013 despite the fact that earnings had grown strongly. We accumulated the stock around the $6, placing it on a multiple of approximately 12x with 15-20% organic eps growth expected over the coming year.

In analysing the company we found 2 things that may have held back other investors:

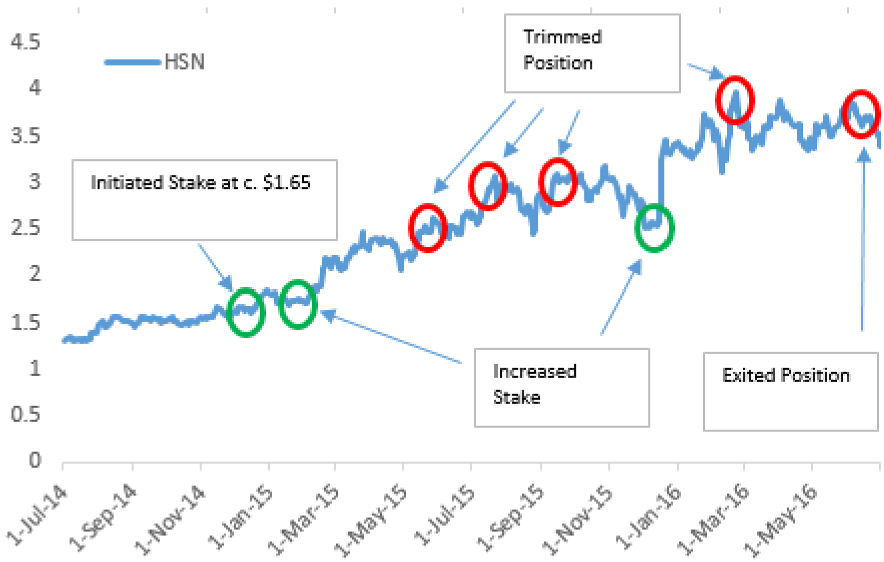
1) The balance sheet did appear stretched particularly as the tangible assets of the company are comparatively low. However, if you looked at the interest cover it sat at over 6 times

which gave us a lot of comfort in their ability to service their debt (along with their high level of annuity style revenue);

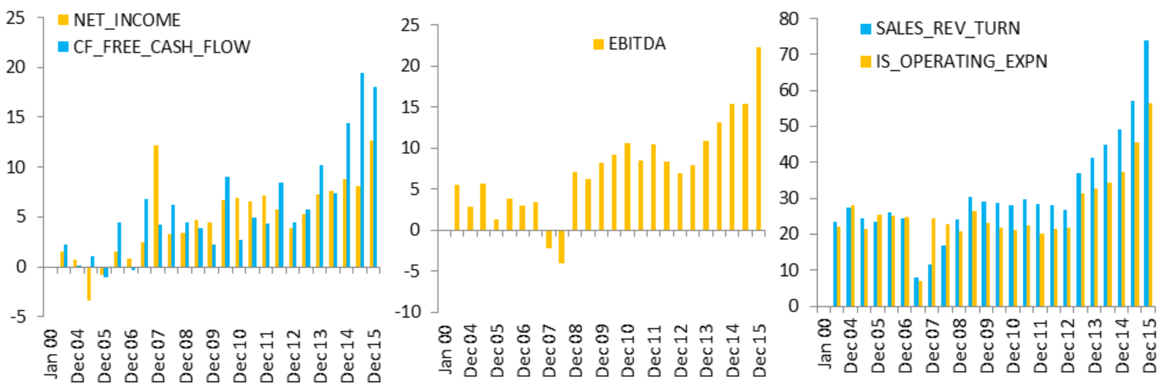
2) There was also some confusion in which profit number to look at. A number of analysts were looking purely at the headline number which stood at $67.1m; we preferred to use the underlying profit which stood at $93.3m (which strips out non-cash amortisation costs associated with acquisitions). The Free Cash Flow of the company aligned with the underlying profit.

The growth continued over the next two years and the company then merged with Vocus. The merger made good sense with M2 effectively having a client book and Vocus having the supporting infrastructure. It remains a core holding in the fund with the company now the fourth player in the Australian broadband space and well positioned to take market share off the larger players.

Hansen Technologies

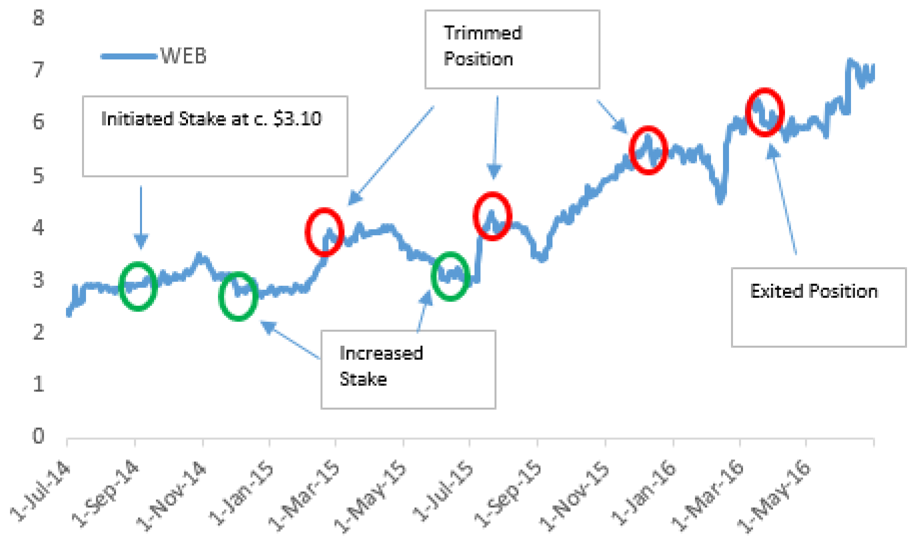


Hansen Technologies is a software company that provides billing solutions for large Utilities and Telcos. The company listed back in 2000 but it wasn't until 2007 that they became consistently profitable post the sale of some non-core assets. We first purchased the stock in late 2014. Profitability had started to raise and the near term outlook was strong.

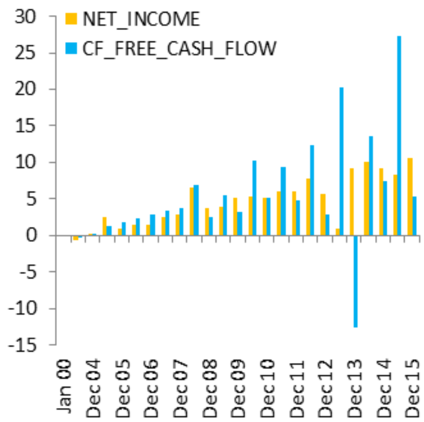


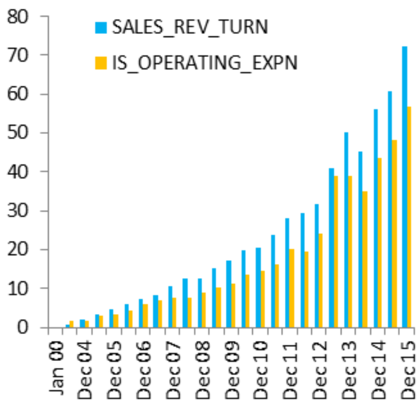
Since then the business has really come into its own with consistent revenue growth through new contracts and selective offshore acquisitions. The balance sheet has been utilised on the back of increasing earnings and has led to the growth profile in the near term looking very strong. The fund purchased its initial stake back in late 2014 at 15.5x forward earnings and has seen it rerate into the high 20s. The fund has recently exited the position completely on valuation grounds.

Webjet



Webjet is an online travel agency. After a year of transition in FY13 as it bedded down some acquisitions and profits bounced back strongly in FY14. On the back of this strong rebound in profitability we entered the company in August 2014.

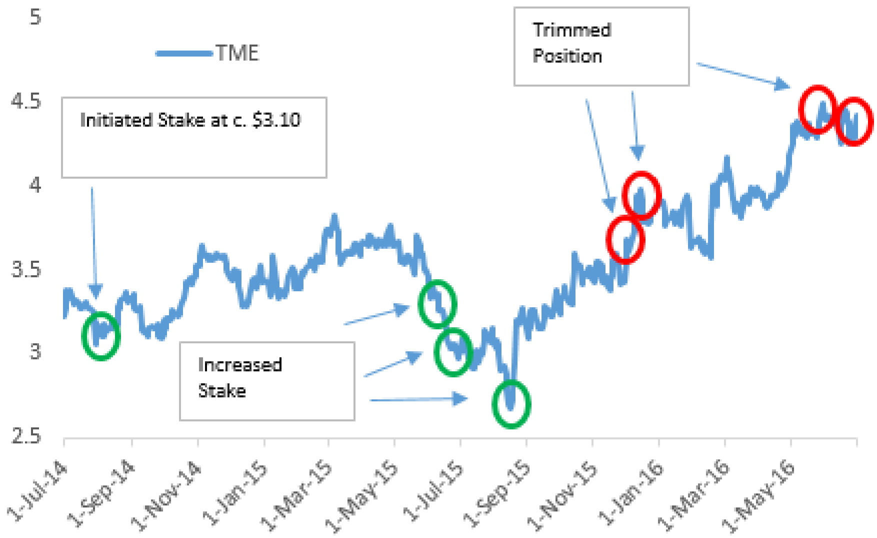




Whilst part of that impressive result in FY14 was due to a lower tax bill (thanks to the previous year's loss from their acquisition of Zuji), the business was well positioned for growth. The key growth was set to come through their B2B (Business to Business division), which at the point was breakeven. The dividend was increasing and the balance sheet was (and continues to be) net cash. At 12.5x earnings and with a 4.5% yield the valuation was compelling.

The stock has seen a significant rerating to over 22x next years earnings. This is expensive for a stock which still makes a majority of its earnings through a consumer focused business. Given the recent downgrades from Qantas, Virgin and Flight Centre, we thought the downside risk was increasing and completely exited the stock.

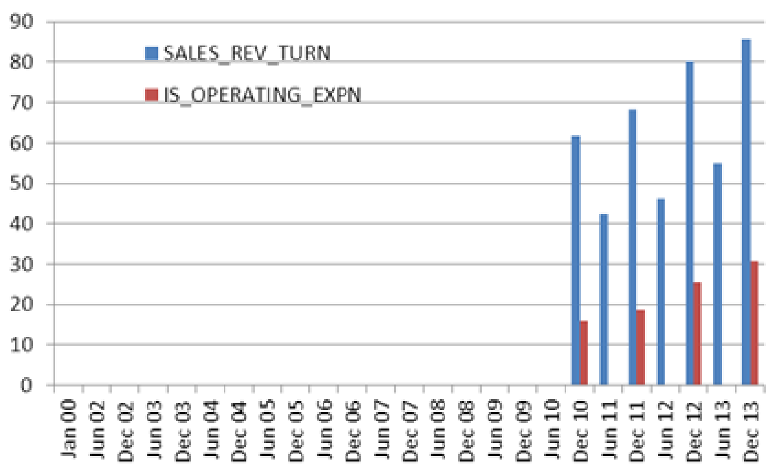
Trade Me

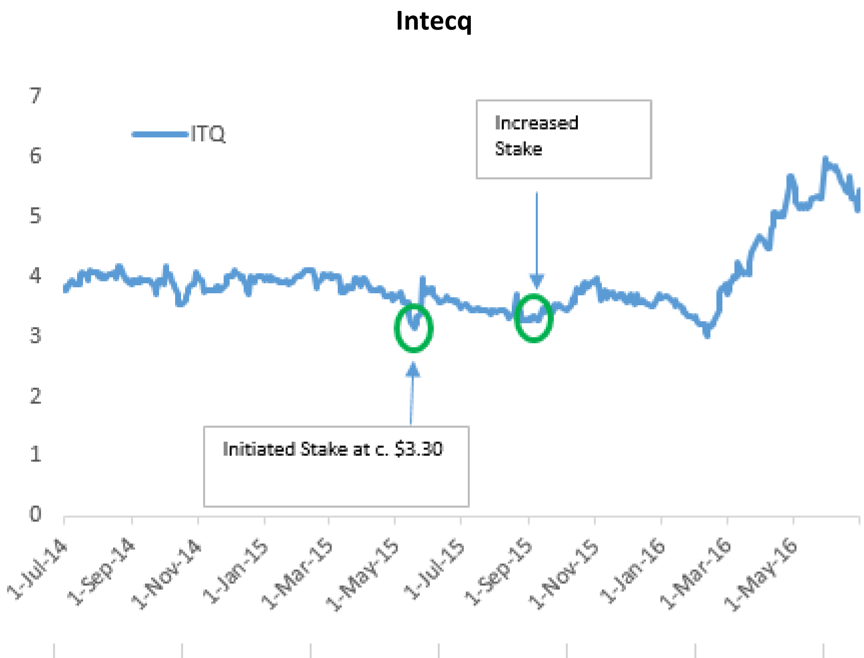


Trade was one of our earliest positions, we had seen the shares have trade down over the course of 2014 and eventually hit $3.06 on July 30 (down 4.1% on the day) as the company announced changes to its pricing structure for property agents. Whilst this was a negative, the overall implications to the value of the company when property made up just 15% of revenue was minimal. In the greater scheme of things investors had been disappointed by the companies FY14 earnings growth which was essentially zero. The company was trading at 16.5x FY14 earnings which is a very full price for a company with no growth.

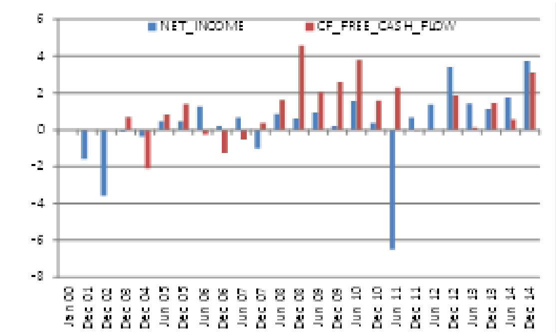
In buying the company at these prices we are essentially saying that the FY14 year is a one-off and that growth will resume in FY15. Two things give us comfort that this is the case. Firstly, the Trade Me brand is a strong one and they are the dominant player in the NZ online classified space and have multiple growth channels. The second is we need to look at why earnings were flatlining.

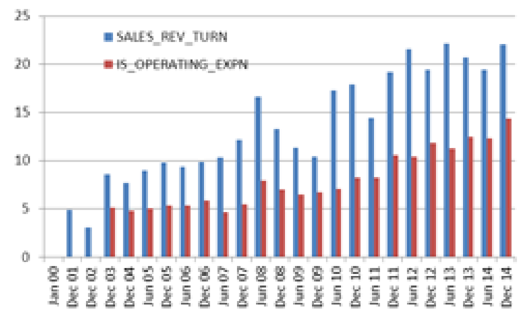
If we look back at the 2014 first half result, Revenue grew 6.6% y/y but NPAT only grew 1.7%. The company increased costs primarily through increased headcount to support growth initiatives and acquisitions. We expected the expense growth to moderate in FY15 and FY16 resulting in a better NPAT outcome. As a result we were happy to pay 16.5x for a company with a strong brand and dominant market position.





Intecq (formerly known as eBet) is a gaming systems company with a presence across Queensland, NSW, Victoria and Tasmania. It also has a small offshore exposure. Revenues have grown solidly over the last 10 years and that has led to consistent profits in more recent times. When we bought the stock n 2015 we believed that recent increases in profitability had been masked by the decline of a legacy contract.



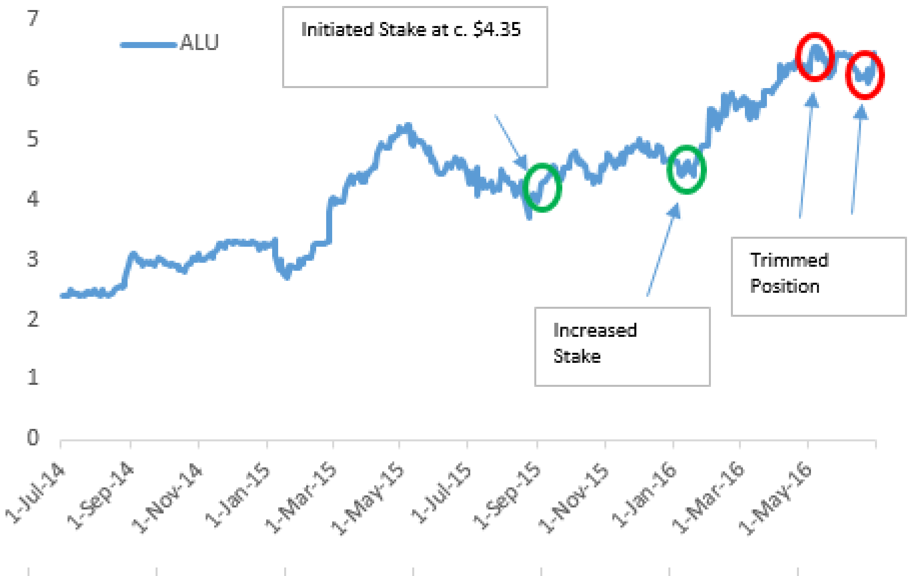


In the 2010 financial year the company got a boost from a deal with WMS to be the exclusive distributor of their products in Australia. More recently this deal has gone to the wayside with Scientific Gaming taking over WMS. The result has been a drag on revenue in recent periods. Despite this the company has managed to maintain and in recent periods increase overall revenue with the increased rollout of their own products. The below table shows the contrast in the divisions with WMS revenue (Gaming machines) falling 92% over 2014 whilst Gaming systems revenue rose 45%. The overall result was revenue growth of 6%. With the falls from the WMS contract largely finished the company's overall growth rate should improve from here.

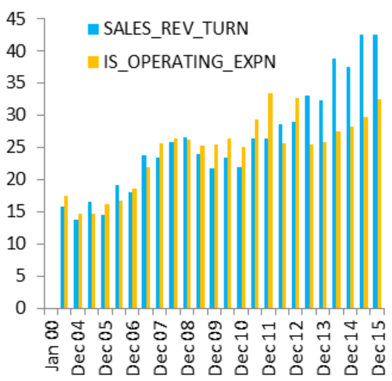
Business Segments	Dec 2014 ($,000)	Dec 2013 ($,000)	Variance
Revenue	22,372	21,040	+6%
Gaming Systems	9,289	6,427	+45%
Gaming Machines	255	3,138	-92%
Gaming Operations	12,518	11,144	+12%
Others	310	331	-6%

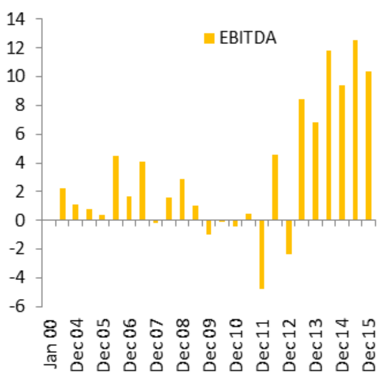
Thanks to the convoluted makeup of the earnings, we entered the stock at sub 10x earnings and strong expected growth.

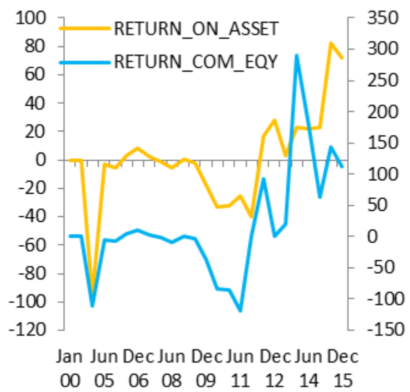
Altium



Altium is a software developer for the design and manufacture of Printed Circuit Board. It is the 4th largest player in the market with a 10% market share that is growing. Revenue and profits have grown consistently in recent years. Margins continue to increase on greater sales volume and returns are up.







The company has a goal to reach US$100m revenue by FY17 (currently $80m) and if it were to reach this the valuation is quite compelling despite high current multiples. We purchased the stake in late 2015 and whilst we have trimmed some of the position on strength, it remains a core holding.

What didn't work?

When investing it is always important to acknowledge your mistakes and to learn from them. In valuing a company you are inherently trying to forecast the future. By definition the future is unknown and hence very difficult if not impossible to predict. Therefore, things are going to happen that you don't expect and you will make mistakes. One of the most important things in investing is to realise these mistakes and to react to them accordingly.

Not everything has worked for us over the last two years. Three positions have performed particularly badly, these were:

- RXP Services
- Slater and Gordon
- Life Healthcare

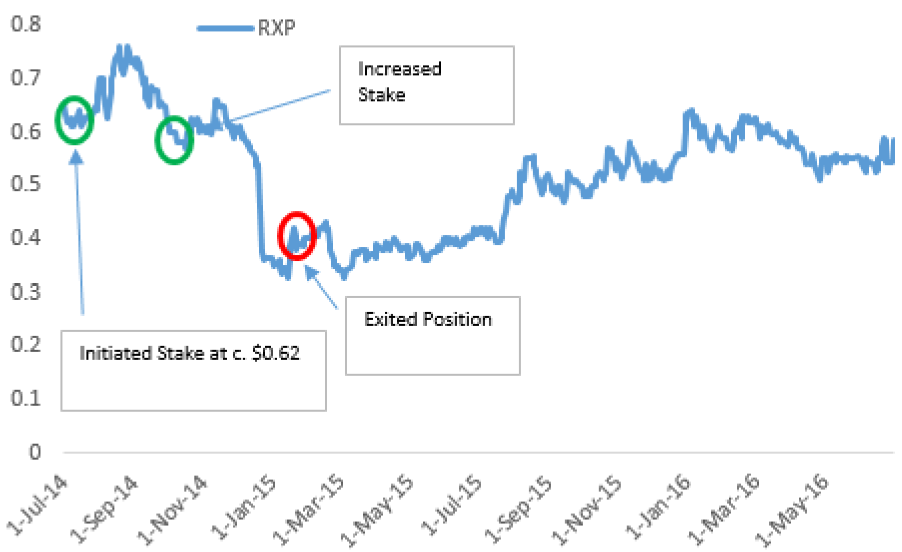
In all three cases we sacrificed quality in favour of valuation. One of the first fund managers I ever worked for had a great quote that I have to constantly remind myself of – "Good stock, not cheap. Cheap stock, not good."

Thankfully in all three cases we allocated minimal capital to begin with but also we realised our mistake relatively early and moved to limit our downside.

RXP Services

RXP is an ICT consulting business. It essentially provides services to other businesses. The key variables for the profitability of these companies (that they can control) are the number of staff they have and the utilisation of those staff. In the 2014 December half, RXP believed they had several key projects due to start before the end of the year and accordingly allocated a number of staff to them. Unfortunately the company advised the market towards the end of that period that a number of contracted projects had postponed their start date. The result of this meant that the company's utilisation of staff went from its usual 80-85% to below 75% for the half. In other words, the company was paying staff that weren't generating revenue and this impacted profits.

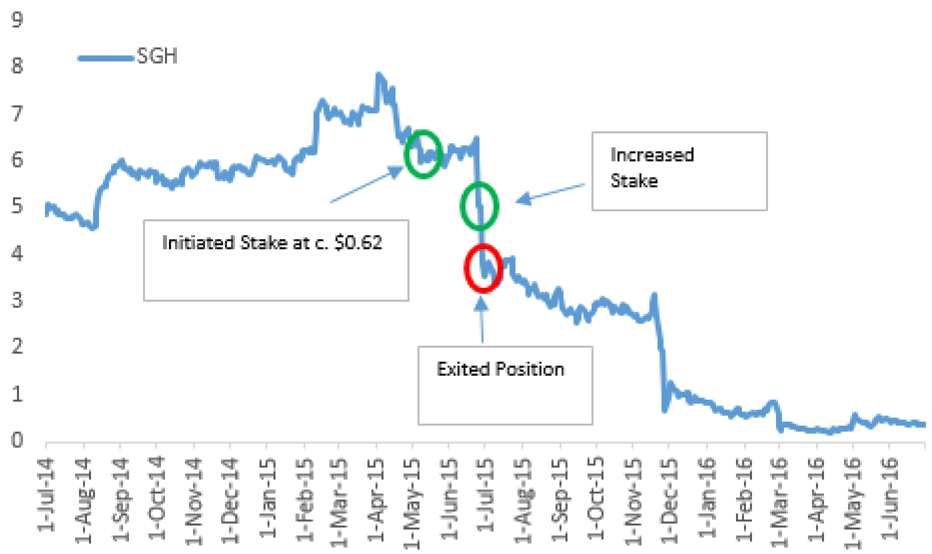
Whilst profitability has returned since, we choose at the time to remove the risk of uncertain earnings from the portfolio.



Slater and Gordon

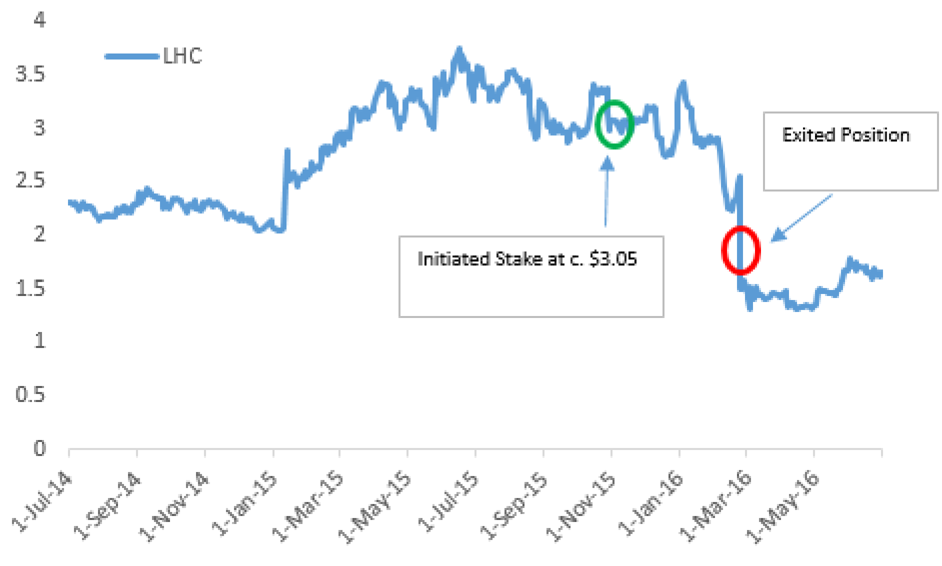
We are truly embarrassed that Slater and Gordon is on this list. All the warning signs were there, yet we got suckered in by an attractive valuation. The key warning signs should have been a lack of cashflow and a large amount of debt. The company's operating cashflow has never met the vagaries of its accounting profit and if that trend continues the company will never pay off the debt taken on from the acquisition of Quindell in the UK.

Thankfully, we recognised our mistake early and exited the position for a much smaller loss than otherwise could have been realised. The company is now questionable as a going concern.



Life Healthcare

Life Healthcare was only a small position for the fund but did experience a sharp decline in a short period of time. The company is a distributor of medical products and at the time of purchase we acknowledge key risks for the business are loss of distribution contracts as they don't own the products.



Risk

Finally we wanted to touch on a point close to our heart, risk management. It would be easy for us to simply say the volatility of our portfolio is 11.51% versus the All Ords volatility of 17.99%, and hence our portfolio is lower risk.

	QBFAM	All Ords	Small Ords
Std Dev	11.51%	17.99%	16.61%

Ultimately though, we don't buy into the notion that volatility equals risk. Risk to us is the permanent impairment of capital. To that end, our worst drawdown is better than the market (-8.20% vs -16.41%).

The key way we manage risk is through our ability to hold cash. Our cash levels have varied over the last two years. Typically when the stocks we own rally, we will reduce our exposure. If stocks we like fall, then we look to increase our position. Through this dynamic process not only can we lower risk by reducing our exposure to higher priced markets but we can also take advantage of opportunities that arise in sell offs.