<u>Samuel Terry Absolute Return Fund</u> – June 2018 quarterly report

The Fund's performance (Founder units, net of fees) and those of the Australian All Ordinaries Accumulation Index and the MSCI World Equities Index, are as follow:

To 30 June 2018	STAR	All Ords	MSCI ($A)
1 quarter	-0.5%	8.0%	4.4%
1 year	35.4%	13.7%	15.3%
3 years (%p.a.)	29.0%	9.5%	9.7%
5 years (%p.a.)	30.1%	10.3%	14.2%
7 years (%p.a.)	26.0%	9.0%	14.0%
10 years (%p.a.)	22.0%	6.2%	9.0%
Since inception on 1 Nov 2003 (%p.a.)	16.2%	9.0%	7.6%

There are several reasons for the Fund's poor quarter. Holding about 35% of the Fund in cash is unhelpful in a rising market. Our biggest loser was **Kangaroo Island Plantation Timbers** (22% of the Fund), which fell 10% for no new reason. Our **call options on the S&P 500 Index** caused a loss of about 1% to the Fund. Two of our new positions also fell 18-19% from our average cost. We bought more as prices fell, continuing our longstanding practice of buying "falling knives".

Offsetting the above losses, our **call options on the ASX 200 Index** added over 3% to the Fund's performance. Option volatility remains cheap and we still like owning call options to give us exposure to upward moves in the market, while holding lots of cash to protect our downside.

We added six new names to the portfolio during the quarter. They are a motley crew with little in common, except they are unloved by the investment community. Five of them trade at a large discount to net asset value (NAV). All six have risks and problems; indeed three of them have been targeted by short sellers[1]. In each case, we see some merit in the short sellers' theses, but think that the prices we paid compensate for the warts. One of our new names is a fast growing tech company backed by a very successful board and management. Another is a listed investment company which has generated returns of over 18%pa for more than ten years, but trades at about half of NAV. Five of our new names have no debt. Two of those trade for less than their net cash, although both are rapidly burning cash to build their businesses. As usual, we will identify and explain each of these new companies when appropriate.

As this is our first quarterly report, we decided to write a longer report on one of our companies. **Salmat Limited** (4.8% of the Fund) is best known as Australia's leading letterbox catalogue distributor, an industry it pioneered. When we first bought its shares in December it also owned a significant yet loss-making call centre operation, and a leading Philippines based labour

[1] Short sellers are investors who bet on share prices falling. Sometimes, short sellers publicise their arguments against companies in order to accelerate the share price decline, and in some cases to hasten the demise of the targeted company.

outsourcing provider. This un-sexy assortment of businesses, plus a poor track-record of capital allocation explained why the share price had dropped 90% in the previous ten years. Perhaps co-incidentally, the founders and major shareholders had retired from the business nine years ago.

Understandably, the shares were cheap. On our calculations the shares were trading at less than half the sum of Salmat's parts. At our average cost, our acquisition price was covered by the company's net cash plus a large franking account balance.[2] We figured that if management could bring the call centre to break-even, earnings and cash-flow would increase sufficiently for the resumption of dividends. Turning around the call centre would be difficult since Salmat would most likely have to buy a peer to obtain the required scale for profitability. We were not comfortable investing on this basis.

What persuaded us to buy the shares was the founder's return to an executive capacity. Upon analysing his past decisions, we concluded he is a rational capital allocator and, as a large shareholder, his interests are aligned with our interests. We became comfortable that the management culture had shifted towards maximising shareholder value.

In March, Salmat announced it had entered into an agreement to sell the call centre business for $53m, more than half its market cap. We took this as validation of our investment thesis and bought more shares.

The shares have generated a 32% return since purchase, including dividends. Despite the rise, we remain comfortable with Salmat. Its enterprise value[3] is approximately 4x our expectation for FY19 EBIT[4], which we believe is too low. Even though the catalogue industry is in natural decline, it will still exist in five years and we see numerous paths to sustainable profitability. We think there is value in Salmat and expect management will continue to act rationally.

The Fund's net asset value was $123m or $3.3776 per Founder unit and $13.347 per A Class unit (down 0.87%) at quarter end. 25% of the Fund was in $A cash. It owned securities issued by 22 companies.

Fred Woollard and Nigel Burgess
10 July 2018

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[2] We also love the fact that Salmat has sufficient capital and income losses for it to avoid paying cash tax for many years to come.

[3] Enterprise Value means the market capitalisation of the company, less its cash, i.e. the implied value of the underlying business.

[4] FY19 EBIT means Earnings Before Interest and Tax in the year to 30 June 2019.