# Long Tail Asset Management

# Annual Review: 2011

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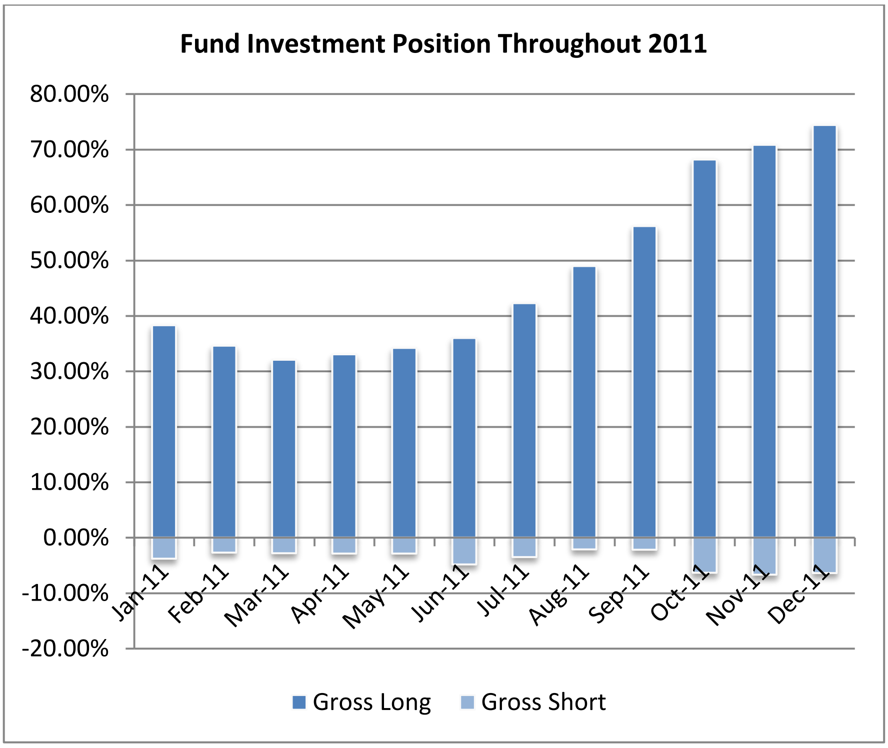
# Contents

## Introduction

We used the volatility in equity markets over the year to progressively increase the fund's invested position. The fund is currently 74.4% long, 6.4% short and 80.8% gross.

The fund's capital is concentrated in four discrete ideas. Three of these ideas are long investments which we refer to as US Wagering, Passenger Leverage and Newbanco. The fourth is an option position intended to gain from Japan's relentlessly deteriorating sovereign risk profile.

We started the year holding a significant cash balance and seeking appropriate investments - we concluded it with the unit price intact[1] and owning a concentrated, focused portfolio of businesses which we are optimistic will deliver solid absolute (inflation adjusted) returns in the years ahead.




We view the fund's current positioning as being reasonably balanced. The equity investments are large enough both individually and collectively to meaningfully contribute to performance and we regard the available cash as providing some flexibility.

Looking back, we can probably divide the year into three periods. The early part of the year was reasonably benign with markets trending marginally higher. Since March, volatility has increased and markets started to move downwards. At first they seemed to react to the US economy slowing faster than anticipated, particularly given the prior and ongoing monetary stimulus programmes. More recently the focus has shifted to European sovereign risk and credit risk issues.

We feel the market's current focus on Europe is to some extent misplaced. While we appreciate Europe's problems, the market is focused on issues that have been evident since the UK banks were

[1] The fund returned -3.10% for calendar year 2011.

recapitalised three years ago. We do not regard the risks today as being greater than they were six months or a year ago. Instead, we think the key change is that due to the recent correction in asset prices, investors are now being compensated for assuming these risks. Rather than reacting to negative headlines about Europe by becoming more defensive and risk averse, we are responding to the decline in asset prices and the increase in available risk premiums by becoming more fully invested.

Regardless of whether the concerns are valid or perceived, the fear that is sweeping markets is creating real negative economic consequences.

Weighing up the environment, we feel we have three choices. We can:

1. Sit in cash and wait for the uncertainty to clear;
2. Back our view aggressively by investing in businesses that are at the centre of the storm, believing we will be well rewarded if our view proves correct; or
3. Invest in specific businesses we want to own longer term, being of a view the current weakness is creating an opportunity to put capital to work.

The first option may be (perhaps surprisingly) the most risky. The fund held a very material cash weighting in early 2011. This gave us a sense of security as markets started to correct. When we considered the high cash weighting we felt our greatest risk was not that markets would recover but that the markets' fears about global sovereign risk and credit risk would actually be realised. If we take these concerns to a doomsday conclusion it runs along the lines of sovereigns are broke, there will be a debasing of fiat currencies and all things paper will be essentially worthless. In this environment, cash is possibly terminal.

The second option is binary; if we are right we will realise significant profits, if we are wrong we will realise significant losses.

Our bias is clearly towards the third option. We think the current weakness is providing an opportunity to invest in operating businesses, which we regard as good longer term investments and an effective hedge against inflation, at reasonable prices. In this context we are happy to carry the volatility of equity investment. The key issue for us is to identify and buy suitable businesses to own longer term, not what the market prices them at from one day to the next.

## Invested Position

The fund is currently invested as outlined below. Our US investments make up the largest geographic allocation of capital at 36%.

In relation to foreign currency exposure, we have elected to hedge the majority of the fund's Euro exposure back to Australian dollars and to leave our US dollar exposure unhedged.

Over the year we have invested around 2.3% in buying equity and currency derivatives. This is largely Japanese Yen / US dollar put options we have discussed previously.

| | Long (%) | Short (%) | Currency (%) |
|---|---|---|---|
| Australia | 20% | 6% | 60% |
| United States | 36% | 0% | 36% |
| UK / Europe | 18% | 0% | 4% |
| Total | 74% | 6% | 100% |
| | | | |
| Derivatives (annual cost) | 2.3% | 0 | na |

Notes: Totals may not add due to rounding. As at: 30-Dec-11.

The following table provides more detail on the invested position for each tenet. In the June 30 2011 Fund Update we highlighted our thought process around the US Wagering and Passenger Leverage tenets. Over the past six months a key shift in the fund has involved increasing the investment in the Newbanco tenet from 3.9% to 18%. These three tenets now represent 48% of the fund's capital.

| | Australia | | United States | | UK/Europe | | Total | |
|---|---|---|---|---|---|---|---|---|
| | % | no/. | % | no/. | % | no/. | % | no/. |
| Tenet 1: US Wagering | | | 17 | 2 | | | 17 | 2 |
| Tenet 2: Pax Leverage | | | | | 13 | 2 | 13 | 2 |
| Tenet 3: Newbanco | 15 | 3 | 3 | 1 | 0 | 1 | 18 | 5 |
| Tenet 4 | | | 8 | 2 | | | 8 | 2 |
| Tenet 5 | 4 | 2 | | | | | 4 | 2 |
| Tenet 6 | 2 | 1 | 5 | 1 | | | 7 | 2 |
| Other long | | | 3 | 1 | 5 | 1 | 8 | 2 |
| Gross long | 20 | 6 | 36 | 7 | 18 | 4 | 74 | 17 |
| Gross short | 6 | 2 | | | | | 6 | 2 |
| Gross invested position | 27 | 8 | 36 | 7 | 18 | 4 | 81 | 19 |
| Derivatives (annual cost) | | | | | | | 2 | 2 |

Notes: Totals may not add due to rounding. As at: 30-Dec-11.

Below we detail the Newbanco tenet and discuss Semgroup, an investment the fund holds that has recently undergone a bankruptcy restructuring.

## Newbanco

Eighteen percent of the fund's capital is invested in the Newbanco tenet. There are five investments that populate this idea ranging in size from micro to large capitalisation companies located in Australia, UK and the US. The investments include banks and financial services businesses.

The common traits we perceive amongst these businesses are:

- They are well capitalised, they have strong balance sheets and liquidity positions, and limited or no loan exposure dating pre-2007. We perceive their capital positions enable them to organically grow their businesses in the current environment. Minimal loan exposure pre-2007 gives us greater transparency as to the nature and composition of their balance sheets;
- They have existing operations, systems and infrastructure to build from; and
- Good management. We have made a subjective judgement that we are prepared to back management's ability to reinvest capital in the current environment - whether through building their businesses organically or through acquisitions. We formed this view from observing the individuals through the GFC, meeting with them, and gauging their current results / progress.

We believe a loan written today should be very profitable due to the repricing of assets over the past three years, an increased focus on credit risk and a reduction in the amount of available credit. We also regard a strong balance sheet and liquidity position as being a key differentiator, allowing these businesses to focus on organic growth rather than being consumed by managing legacy problem loans.

Often we come across a business or situation that strikes us as interesting but are unable to find a suitable investment. We maintain a watch list of these businesses in case we get an opportunity in the future. It also acts as a prompt to help us identify associated ideas.

BankUnited came onto our radar in May 2009 when it was acquired from US federal regulators by a group of private equity investors led by John Kanas. BankUnited is a Florida based bank that has the dubious honour of being the country's second largest bank failure in the GFC. At the time it failed, the bank had $13 billion in assets, $8.5 billion in deposits and 85 branches. 73% of their loan portfolio was residential mortgages, 60% of which were option Adjustable Rate Mortgages sourced predominately from brokers.

The bank was seized by federal regulators on 21st of May 2009 and immediately transferred to Mr Kanas and the private equity group to reopen the next day. The loan portfolio was written down to a market value, the FDIC (Federal Deposit Insurance Corporation) injected $2.2 billion and the private equity group invested $900 million. More importantly, the private equity group also entered into a loss sharing agreement with the FDIC under which they would recover in excess of 100% of the written down loan valuation under worst case credit performance – that is, the FDIC covered 100% of any loan losses.[2]

In essence the private equity capital appeared protected under a worst case credit scenario. They also have an enviable base to build from including the banking infrastructure and footprint of the largest Florida based lender. Further, the management team has a strong track record, notably from building North Fork Bank in New York which grew organically and through acquisition from 1986 to its sale in December 2006.

In retrospect the timing of the private equity acquisition of BankUnited was also outstanding. It coincided with capitulation of the sector globally. This transaction, greatly augmented by the loss sharing agreement, essentially met our ideal investment under the Newbanco tenet. We added BankUnited to our watch list and felt a great degree of respect and some envy for the position Mr Kanas and the private equity group appeared to have secured for their investors.

In early 2011 BankUnited listed on the NYSE and the private equity group sold one-third of their holdings. At the time, it had net tangible assets of $1.3 billion, market capitalisation at IPO of $2.5 billion and was priced at 14 times trailing earnings. The business came to market with a tier 1 ratio in excess of 40%.

The valuation looks absurd at first glance versus the incumbent US banks but what the market seems to be recognising is the investment offers a:

- Clean platform, with scale, to start lending from;
- Capital position that puts them in a position to aggressively grow their loan portfolio and acquire as they see opportunities; and
- Management team with a history of successful execution of both organic and acquired growth.

As a part of our US trip in October 2011 we met with management in Miami Lakes and visited a number of their branches in the area. We had an underlying concern that the dynamic may be the New York bankers, backed by their private equity partners, were essentially looking to build something quickly and then onsell it. Our overriding sense after spending some time with management was quite the opposite. It appears a traditional, almost old style, regional banking franchise. Their focus seems to be genuinely on building relationships and a business longer term. To an extent this view is supported by the fact that they have not made a significant acquisition to date despite their surplus capital position and strong market expectations to do so.

The current management team relocated the head office into an existing non-descript operations / processing centre well outside the central business district. The layout of the executive office space is modest and small. We were early for our meeting and sat in a meeting room for 15 minutes where we could observe the layout, interaction and activity level – this left a favourable impression before the meeting had even started. Below are pictures of BankUnited's former and current office buildings.

[2] The agreement is conditional on, among other things, BankUnited staying in compliance with the servicing and reporting requirements of the agreement.

Former office: 255 Alhambra Circle, Coral Gables, Florida

Current office: Miami Lakes


We established a position in BankUnited at $24.40 and it now represents slightly more than 3% of the fund. We are valuing the business as a multiple of book plus the NPV of the loss sharing agreement unwind. At $24.40, this represented 1.3 times book value plus the value of the unwind. The share price is currently $22.10. We are clearly paying a premium to the private equity entry price and a premium to the peer group valuation. We think this is warranted given the unique position the business holds. We expect that as they gain traction in their lending activities there is the opportunity to drive these gains considerably given their relatively modest market share. Ultimately the key item we are focussed on is their ability to organically grow the lending activities of the bank, which if done successfully will flow through to a growing book value. Given the nature of the business, we expect there will be hiccups in this quarterly trajectory but over time we perceive that they are well placed to build a meaningful, valuable banking franchise.

## Semgroup

The fund holds a 4.5% position in Semgroup. We acquired this position from mid-July 2011 to mid-August 2011 at an average price of $22.58 per share. On 24th October 2011 Semgroup became the target of a takeover bid by Plains All American at $24.00.

Semgroup is currently trading around $26 per share and its enterprise value is around $1.3 billion. In 2011 we expect the business to generate a pre tax ungeared cash coupon of approximately $105 million (before growth capital expenditure) - we perceive this coupon can grow considerably with incremental development capital expenditure and increased utilisation of existing assets.

The key insight we feel we held regarding Semgroup following its bankruptcy was the fundamental change in their business model away from being a volatile marketing / trading business towards a fee based revenue model. We had regarded the business as owning reasonable quality assets and felt a fee based model was more appropriate and sustainable - rather than using the assets to facilitate marketing / trading activities. We believed we had confirmation of this change from the results the business delivered following its relisting in October 2010.

When we acquired the investment we thought about the numbers as summarised in the table below.

| | 2011 |
|---|---|
| Shares on issue (1) | 44.3m |
| Our average buy price | $22.58 per share |
| Implied market capitalisation | $1,000m |
| Estimated net debt (2) | $180m |
| Estimated enterprise value | $1,180 |
| | |
| Estimated pre tax cash ungeared coupon (3) | $105m |
| | |
| Estimated pre tax ungeared yield | 8.9% |

Notes: The estimates are pre the sale of SemStream, the Rose Rock IPO and debt refinancing. Totals, ratios, etc may not add due to rounding. (1) Includes dilution for warrants and unvested restricted shares. (2) Reflects gross debt plus some other liabilities less cash held, estimated cash from warrants and SemStream inventory allowance. (3) Reflects EBITDA / operating cashflow pre interest and tax less maintenance capex and some additional expenses not otherwise captured.

Semgroup is a US based company with an event filled last few years, culminating with its bankruptcy in 2008 (in 2008 Semgroup came unstuck as it seems to have been on the wrong side of the strong rally in the oil price. This resulted in significant losses and a bankruptcy filing in July 2008. Creditors took losses overall in the vicinity of 50%).

We have some familiarity with a number of the trends occurring in the US energy sector, including the rise of shale gas supply, increase in natural gas liquid extraction and processing, increase / change in North American oil supply, and others. We are interested in how these dynamics will create opportunities for new infrastructure (pipelines, processing facilities, storage, etc) and leave other infrastructure stranded.

Ideally we want to find companies that own quality assets that are well located given the trends referred to above and have the opportunity to invest in / around these assets to generate favourable incremental returns. We also want to buy cheaply based on existing (not future) earnings, reasonable management and a good balance sheet.

Our research led us to Semgroup. Semgroup's assets consist of an eclectic range of oil storage and pipeline assets in and around Cushing, and gas processing assets in Canada and the Texas / Oklahoma area. They also have a petroleum storage facility in the United Kingdom and a small Mexican asphalt business. Some of the assets are new or recently refurbished.

Semgroup emerged from bankruptcy and relisted on the NYSE during October 2010, owned by its creditors. Importantly, it emerged with:

- new management headed by a CEO with a long track record and reputation for good operational expertise;
- new tolling based business model focused on providing fee based oil and gas pipeline, storage and processing services to third parties; and
- new balance sheet, with a low level of debt.

Below we have provided considerable detail regarding the major assets owned by Semgroup. We felt this background enabled us to build confidence in the earnings power of the individual assets and the business as a whole, and was necessary for us to gain confidence in our valuation of the business. The detail outlines how Semgroup has been able to extract incremental returns to date and the opportunities for the future. We also felt this detail provides greater insight to our research process.

<u>White Cliffs Pipeline</u>

Our initial interest in White Cliffs was sparked a few years ago as it was being developed by the pre-bankruptcy version of Semgroup. What attracted us was the genuine need for the pipeline (it seemed to relieve a key constraint of producers in the Denver-Julesberg (DJ) Basin seeking a market for their oil) and the economics looked attractive.

White Cliffs is a 12 inch 525 mile pipeline that provides the only pipeline link between the rapidly developing DJ Basin in Colorado and the oil market hub at Cushing, Oklahoma. Prior to White Cliffs producers were restricted to the two local refiners or trucking oil to other regions.

White Cliffs commenced construction prior to bankruptcy and came into operation in mid-2009 with a capital cost of approximately $235 million. As a result of the agreement entered into with foundation customers and the bankruptcy process, Semgroup's interest in White Cliffs was reduced to 51% in 2010.

Given its monopoly position, White Cliffs obtained FERC (Federal Energy Regulatory Commission) approval for its throughput rate of $5.20/bbl for foundation customers and $5.70/bbl for subsequent customers. The rate base for the asset was set at around $250 million and the corresponding return around 14% on an ungeared pre tax basis. Assuming gearing of 50%, this translates in a pre tax equity return of around 20%. We believe this is very attractive given the underlying risk profile.

White Cliffs had an initial capacity of approximately 30,000 bbl/ day and the foundation customers contracted two-thirds of this capacity for around 5 years on a take or pay basis.

Strong demand for capacity on White Cliffs saw its utilisation reach capacity in early 2011. We thought the economics at this point looked attractive – the pipeline was generating revenue of around $55 million with operating expenses of $14 million and depreciation another $10 million. In other words, an ungeared pre tax cash coupon of $40m+ and EBIT of $30m+. Relative to the capital cost of $235 million, this implies an ungeared pre tax return of 17% or 13% respectively.

Demand for capacity on White Cliffs has continued to rise and it has been able to easily expand capacity with pump stations (which increase pipeline flow rate) - initially one pump was installed to expand capacity to around 50,000 bbl/ day. Semgroup already owned the pump and the cost of installation was very small. During the September 2011 quarter, use of the pipeline grew to nearly 42,000 bbl/ day.

Given the relatively fixed cost nature of the pipeline, a large part of the incremental revenue falls to the bottom line / shareholders. Demand permitting, management expect that with small additional capital expenditure, capacity can be increased to 70,000 bbl/ per day.

Cushing Storage

Cushing is a major oil hub in the US and the price settlement point for West Texas Intermediate on the New York Mercantile Exchange.

The oil flow dynamics around Cushing have changed in recent years as the increased flow from the north (e.g. Canada, Bakken, DJ Basin, etc) has congregated at Cushing and there has been insufficient take away capacity from Cushing.  We believe it is only a matter of time before new pipeline capacity is added with the Keystone XL pipeline (to be developed by TransCanada as an extension of the existing Keystone pipeline from Canada to Cushing) probably the leading contender.

During October 2011 we met with most of the companies that have storage capacity at Cushing and visited the oil storage tanks. The tanks are primarily owned by 5 or 6 companies with Plains All American being the largest with around 18.5 million bbl of capacity. The tanks are located on farm land a few minutes out of Cushing and one hour by car from Tulsa.

In 2008 Semgroup had just over 1 million bbl of oil storage capacity at Cushing. This has grown to 5.05 million bbl currently and will reach 7.0 million bbl in 2012. Semgroup has contracted all of its capacity (it does not build and hope the demand comes) on a take or pay basis for approximately 5 years. They also own enough land to expand their capacity to around 13 million bbl.

The economics of storage capacity is broadly as follows. Tanks have a new construction cost of around $25 per bbl (give or take). Revenue is derived mainly from a take or pay storage fee which is currently around 40 cents per bbl per month (give or take), EBITDA margins are very high (the tanks are operated remotely and opex is a bit of labour and electricity) and there is minimal ongoing capital expenditure requirements (particularly given Semgroup's assets have all been built in the last 3 or so years). We expect this provides an ungeared pre tax cash yield somewhere in the low to mid teens.

Given the increase in oil flow into Cushing there has been significant storage build in recent times and this may (probably) result in too much storage capacity at some point in the future. This was one of the issues we addressed in our US company meetings. Semgroup seems to be reasonably placed as it has fully contracted its storage for the next 4-5 years. We probably regard the economics of oil storage less highly than we perceive the market does. We suspect generally these earnings are viewed as a longer term stable to growing coupon. Given that there seems to be no limit to building additional storage capacity, we have tended to think of the initial 5 year contracted period as enabling the storage owner to recover most of their construction cost, and then what they receive in the out years as return on this investment. In essence, we think they are net present value positive investments but the earnings profile will likely be more volatile and may be lower than the market is currently anticipating.

<u>Gas Processing</u>

Semgroup has gas processing facilities in the US and Canada.

Semgroup owns three gas processing facilities in Texas and Oklahoma. These facilities take in raw natural gas and strip it of its liquids content. The processed natural gas is then sold for domestic or industrial use (e.g. heating) and the natural gas liquids are sold for further refining and then used in manufacturing products such as plastic, fibre, paint, etc.

Semgroup receives a percentage of the liquids / natural gas revenue as its fee for processing the raw gas. Semgroup's assets are in liquids rich regions which significantly improves the processing economics. Semgroup also receives a fee for some of its 800 miles of gas gathering pipeline assets. Semgroup takes volume risk (raw gas inflow) and price risk on the gas / liquids it sells.

Semgroup has recently completed a new cryogenic plant (the Hopeton facility) which will enable it to take a deeper cut of the raw gas stream and extract a higher amount of liquids. It appears that this facility made a very meaningful contribution in the September 2011 quarter and should significantly lift the US gas assets contribution to group earnings in 2012 and onwards.

Going forward we would expect to see meaningful expansion opportunities around Semgroup's US gas processing assets.

In Canada, Semgroup has interests in four gas processing plants (near Edson, Alberta) which are mainly used to sweeten gas (remove high sulphur content). The plants have an operational capacity of 730 million cubic feet per day. The assets also include 600 miles of gathering and transmission pipelines.

Semgroup owns a 60-70% interest in the facilities with a gas producer holding the balance (e.g. BP / Chevron).

The economics of the facilities are a tolling business model where the facilities are reimbursed their operating expenditure plus a margin plus a capital return. Volumes are at risk, however, a sizeable portion of current throughput is from producers that are tied in to the facility for the life of field /acreage. The assets do not take ownership of the gas while processing or take direct commodity price risk (in contrast to the US gas assets).

Over the past 12 months operational issues have held back the performance of the Canadian gas assets with utilisation dropping from around 90% to 75%. Some of these issues are outside their control (e.g. weather) and the others should be able to be addressed / remedied.

The opportunity for these assets is to expand into and capture increased processing volume from the developing Montney and Douvernay shale formations.

UK Petroleum Storage

This asset is the largest independent petroleum products storage facility in the UK. It is located in Milford Haven, Wales. It has 50+ tanks with capacity of nearly 9 million bbl and two deep water jetties. The facility is able to handle a wide range of petroleum products including gasoline, gasoline blend stocks, naptha, jet fuel, gas oil, crude oil, etc.

Semgroup bought the facility in 2006 and since then invested significantly in the tanks to refurbish and upgrade.

The facility is unregulated and historically has contracted its capacity for terms of up to 5 years on a take or pay basis. In recent years it has been able to achieve reasonable fee increases - the facility has little competition in the UK – the main competition comes from the European northern range ports such as Antwerp, Rotterdam and Amsterdam. Moreover, demand has been strong with utilisation in recent years over 90%.

However, the financial performance of this asset changed materially in 2011 with utilisation falling from 99% in 2010 to just 42% in the September quarter 2011. Not surprisingly EBITDA has also halved.

The key customers for the facility are producers (logistical), European strategic storage (requirement to hold minimum reserve levels) and traders (forward curve or directional bets). Customers are taking a wait and see attitude to re-contracting which seems to be influenced by the relative Brent crude oil price, flattening out of the oil forward curve and disruptions in the Middle East / North Africa. The situation has been made worse as it appears that a large number of contracts were re-negotiated as part of the bankruptcy process with terms expiring around 2011.

While it is still early days, there may be light at the end of the tunnel - at the end of November 2011 utilisation had improved to 52%. Nevertheless, we are not assuming utilisation will return to the previous 90%+ levels.

Longer term it would not surprise us to see this asset sold.

Other assets

Semgroup also owns a few other assets (some of which are relatively small) which we have listed below:

- Oklahoma and Kansas pipeline system – 600 miles of gathering and transmission oil pipeline with throughput growing to over 37,000 bbl/ day during the September 2011 quarter. There should be further operational improvement from these assets as the stigma associated with the bankruptcy dissipates;
- NGL Partners - Nearly 9 million limited partner units and 7.5% interest in the general partner. These interests arose as a result of the sale during 2011 of the SemStream terminals and marketing business;

- Bakken and Platteville - truck unloading and storage facilities; and
- Mexican asphalt business - 13 terminals, 20% market share and sold over 350,000 short tons over the past 12 months. We regard this as a fairly low quality business and longer term would not surprise us if it was sold.

Management have recently disclosed group wide growth capital expenditure opportunities amounting to $350-500 million for the next couple of years. While we would not expect all these projects to proceed, it remains a large amount relative to the current enterprise value of around $1.3 billion. Management's ability to deploy capital wisely and successfully execute will be critical to Semgroup achieving its potential.

Finally, Semgroup is not the only infrastructure company in our portfolio which has emerged from bankruptcy – there are two others which exited, albeit earlier than Semgroup (around 4 years ago). While former bankrupt companies is not an area we set out seeking opportunities, to date it has shown to be prospective and rewarding.

## Japan Sovereign Risk

We published a note detailing our concerns regarding Japan's sovereign risk profile in May 2010 (Japan note link). Since this time, we believe the position has relentlessly and consistently deteriorated. Despite this apparent fundamental deterioration, the Yen has continued to appreciate versus the US dollar and Japanese Government Bonds have remained well bid at nominal interest rates.

We have been reluctant to continue to publish our views concerning Japan (aka "the widow maker"), due to an underlying apprehension of being perceived as "chicken little". We remain strongly committed to the position and the way it is structured means the fund has been able to reset its exposure as the Yen has appreciated. The cost of the position to the fund has been approximately 2% annually. In some respects it is disheartening to tear up close to 20 basis points in performance each month but we approach this cost similar to insurance. If our concerns relating to Japan materialise, we expect it will have significant negative implications for asset prices globally.

There have been a couple of occasions over the past eighteen months when we have felt the markets were on the verge of an increase in focus on the Japanese position. The fear that is currently sweeping through markets concerning Europe is such an occasion.

## Investment Results

The table below summarises the fund's results since inception.

| Financial Year | 2010 | 2011 | 2012 |
|---|---|---|---|
| July | | 1.14% | -1.95% |
| August | | -0.33% | -0.32% |
| September | | 0.60% | -2.18% |
| October | | 2.12% | 0.83% |
| November | | 0.47% | -1.22% |
| December | | -0.24% | 0.27% |
| January | | 0.31% | |
| February | | 1.78% | |
| March | | 1.06% | |
| April | 0.04%* | -1.94% | |
| May | -0.78% | 1.01% | |
| June | -0.76% | -0.70% | |
| | | | |
| Financial Year | -1.49% | 5.33% | |
| | | | |
| Calendar Year 2011 | | -3.10% | |

Note: * Fund commenced on 15 April 2010.

The fund made small gains over the year from its long stock investments. The highlights were the investment in Churchill Downs which appreciated approximately 20% and the large capitalisation Australian tenet which we exited in June 2011 (refer to mandate section of commentary below). Losses from the long portfolio were significantly concentrated in the three European investments the fund holds. These investments are operationally performing well and we largely attribute their share price weakness to the European macro environment rather than company specific issues. We increased the size of these investments late in the year.

Our shorting and hedging activities essentially broke even. These positions did reduce the volatility in the unit price over the year and offered some protection at points of stress in the market. The offset was they acted to dampen returns in the positive months. We currently have no derivative hedging positions in the fund (excluding Yen short) - the only direct downside exposure the fund holds is two ASX listed short positions. Given the increased invested position and lack of downside protection we expect that the volatility of the unit price will increase.

The Yen short cost the fund approximately 2% for the year.

Leaving the US dollar exposure unhedged often felt like a drag on performance, although point to point the AUD / USD was essentially unchanged.

## Mandates

In addition to the fund, we offer individual ASX large cap investment mandates. The mandates are structured as a single idea (potentially single stock) vehicle. The offering provides mandate clients with a concentrated exposure to the discrete ideas we identify in the ASX large cap space.

We regard the mandate offering as something to be considered by large domestic investors who have the sophistication to dimension their appropriate exposure to potentially a single investment. We expect the client would view the mandate as complimentary to their other investment endeavours in the ASX large cap space.

From our perspective, the mandates allow us to focus our research efforts on the few genuine ideas we identify, rather than focusing on the market more broadly. The structure allows us to leverage this work into a significant investment.

To date, we have identified, executed and realised one investment we have regarded as being appropriate for a mandate. The investment was in two large capitalisation companies centred on a single idea. We believe there was the capacity to invest up to $800 million into the idea. We initiated the investment in April 2010 and exited it in June 2011. The annualised internal rate of return (IRR) of the investment was 24%. Over the same period the Australian equity market was broadly flat.

Currently, we have a second idea that we view as appropriate for a mandate. It is a large cap ASX listed business (market capitalisation of near $10 billion) which we expect to realise an annualised IRR of over 20% over the next 3 years.

Please contact us if you would like to discuss our mandate offering in more detail.

## Summary

We regard both the fund and mandate offerings as being relatively unique investment propositions to be considered only by sophisticated investors seeking exposure to the few key investment ideas we identify. The fund is essentially a global best ideas fund managed from an Australian currency and taxpayer's perspective. The mandates are focused on the large cap ideas we identify in the local market. Investors need to appreciate both offerings lack the diversification of mainstream investment products. This narrow focus means the medium and longer term returns will be determined significantly by the quality of our ideas rather than the direction of markets.

The three businesses we have written about over the year - Churchill Downs, Semgroup and BankUnited – are three businesses many investors have never heard of much less seriously researched. To some extent we think this highlights the nature of the fund offering.

We feel we have the appropriate custody arrangements, infrastructure, systems and service providers to support us - enabling us to focus on what we are really interested in - investing.

Each year, in early January, we will endeavour to write a comprehensive annual review highlighting the activity in the fund over the previous year and detailing at least one investment. We maintain the fund's daily unit price and performance history on our website, along with fund updates and brief observations regarding specific businesses or events.

Please contact us if you would like to discuss investing with us in the fund or establishing an individual mandate agreement.

Best wishes for the year ahead.

Yours sincerely,

Miles Webster and Nigel Trewartha

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