23 July 2010

Ganes Value Growth Fund
Investment Manager's Annual Letter 2010

Dear Investor,

The one year gain for the Fund after all fees and expenses was 23.2%, a good result in the current market, and one that compares favourably to the 13.8% return of the All Ordinaries Accumulation Index. After outperforming the market in 2009 during a downturn it is pleasing to outperform again in a positive market.

Last year our letter recapped the events of a tumultuous year. It was a year of events that very few predicted and even fewer acted upon. This year the sovereign debt crisis in parts of Europe, and more particularly Greece, are making business headlines. Austerity rather than stimulus is the new catch-phrase for many governments and markets have become jittery again after a benign few months.

We are cautious as de-leveraging and sluggish global economies will probably translate to lower economic growth which must eventually flow through to company profits. While investors are wise to consider global events when investing in a managed fund, they should also consider the fund manager, their investment strategy, and their track record in managing other people's money.

The *Ganes Value Growth Fund* will mark its fifth anniversary in November. Since inception our investment strategy has remained the same. We seek companies that are able to grow their earnings without the need for major capital requirements, have little or no debt, are easily understood, and most importantly can be purchased at a reasonable price.

We believe our investment strategy works and has produced sound results with less volatility than the market. We have also managed to largely avoid mishaps that can quickly detract from investment returns. What we don't buy is as important as what we do. At the risk of looking boring we have 'passed' on troubled companies and the problems that come with investing in difficult industries, highly leveraged businesses or opaque business structures. If we can't explain the business in a few sentences and how they generate profits then it's highly unlikely it will find its way into the portfolio.

In our first letter to unitholders in 2006 we stated that we seek returns from three areas: dividend yield, future growth in dividends from increased profits, and a positive change in market sentiment when the market underestimates future growth. That hasn't changed and we have almost entirely invested in profitable, dividend-paying companies during the life of the Fund.

This also means we generally hold our investments for a long period of time. Three of the companies from the 2006 top 10 are still there; ARB Corporation, Flight Centre and Treasury Group. While three others: Sonic Healthcare, Blackmores and Fiducian Portfolio Services remain large holdings. A seventh, QM Technologies was taken over by Computershare in 2008.

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PORTFOLIO PERFORMANCE

We started the financial year with a portfolio of 34 companies and 31% cash and were able to find quite a few new opportunities during the year. At the end of June we have 61 companies in the portfolio and a cash weighting close to 13%.

Our top 10 holdings represent 37% of the fund and as a result they do much of the heavy lifting in producing the portfolio returns. Companies in the top 10 have usually been held for years rather than months and this year was little different.

Below are five of the companies in our top 10 holdings that have contributed significantly towards the Fund's performance for 2010.

ARB Corporation

The standout performer in the portfolio this year has been ARB Corporation (ASX Code: ARP). The importance of good management cannot be underestimated in smaller companies and we have been blessed with the Brown brothers running ARB. Along with Reece Australia they may be the most under-recognised management team in Australia.

Despite currency issues, skills shortages, rising steel prices and Chinese imports to combat, the company has surmounted every challenge to continue to produce record results. We bought our first shares for the Fund in February 2006 at $2.79 and have not sold any since. In the past year the share price has risen 60% and the company has also paid a special dividend producing a one year return of 74% for the Fund.

Companies like ARB are very few and far between in Australia and set a high benchmark for other small companies to aspire to.

Thorn Group

Thorn Group (ASX Code: TGA), more commonly known as Radio Rentals, produced a good profit result for the year. Its share price rose 76% contributing strongly to Fund performance. Despite tough trading conditions the company experienced a 10% growth in customer numbers and a 33% increase in normalised profit to $16.4 million. Demand for flat panel display TV's and laptop computers were the key generators for higher sales volumes.

With bank lending remaining tight for borrowers with poor credit history, the company has stated it expects to maintain strong earnings growth into the foreseeable future. However, we are mindful that dealing with people with poor credit histories also means credit delinquencies will be much higher if the economy slows.

McMillan Shakespeare

It was a tumultuous year for McMillan Shakespeare (ASX Code: MMS), the company that provides salary packaging and novated leasing services to government and not-for-profit employees. Salary packaging is very attractive to employees in these sectors because of the Fringe Benefits Tax ("FBT") concessions that they receive.

Because of the favourable tax regime the company also has the business risk that the tax concession could be removed rendering the company much less profitable.

From June through to December the share price rose 40% as the company reported another strong result for 2009 with profits up 18%. This was a standout result when many companies were reporting flat results at best.

However, in January, newspaper rumours that the Henry tax review would recommend removal of the tax concession saw the price plummet almost 35% during the month. We took the view that with the economy still fragile, many of the employees in politically sensitive industries, and an election due, the introduction of the recommendations (which at the time were unknown) was unlikely and we maintained our holding.

The company reported a strong half year result, the Henry tax review recommendations were ignored, and the share price has risen 66% from the January low to become our second largest holding.

Flight Centre

Life as a shareholder in Flight Centre (ASX Code: FLT) is as turbulent as the industry it operates in. The share price rose 92% during the year and the company announced no less than four profit upgrades for 2010.

The company now expects to make a $200 million pre-tax profit this year. This will see it return to the boom profits of 2008 and nearly double the pre-tax profit of 2009. Given the weak global economy and the issues with volcanic ash closing airports across Europe this appears a remarkable achievement.

Australia still provides the company with the bulk of its profits but if the company can improve profits in the UK and turn around losses within the US business the company could generate significantly higher profits in the years ahead. The strength of these respective economies will be important in the company's growth.

Spark Infrastructure

Spark Infrastructure (ASX Code: SKI) owns a 49% stake in unlisted electricity utilities ETSA (South Australia), Powercor and Citipower (Victoria) and is a new addition to our top 10 holdings. Earnings from these high quality monopoly assets are stable and provide a solid and predictable earnings stream for the Fund due to the regulated nature of the industry.

The trust has paid a distribution yield of 11.9% in the last year and more importantly, the distribution is covered by cashflow within the trust. However, capital expenditure is expected to increase significantly over the next few years, which is likely to impact on its ability to maintain the same level of distribution. On the plus side, approved capital expenditure is added to the Regulated Asset Base which directly increases revenue in future years.

Given the increased capital requirements and its potential impact on distributions, the company has announced a strategic review to explore and evaluate a number of options, including '*changes in corporate structure, changes in capital structure, capital raisings and proposals that involve asset sales or a change of control of Spark Infrastructure*'. At the current price, we are comfortable to continue to hold our position in Spark, while the strategic review is undertaken.

CONCLUSION

The Fund has and will continue to seek out companies that are able to grow earnings without the need for major capital expenditure, have little or no debt, are easily understood and can be acquired at a reasonable price. We appreciate your continued support and look forward to updating you on the progress of the Fund next year.

Yours sincerely,

Ganes Investment Management

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The product disclosure statement ("PDS") for the Ganes Value Growth Fund is issued by Officium Capital. The PDS details the terms of the offer and if you wish to invest in the Fund, then you should consider the contents of the PDS, consider whether or not an investment in the Fund is appropriate for you and complete the application form accompanying the PDS. You should also consider the PDS in deciding whether to continue to hold an interest in the Fund.

Past performance should not be taken as an indication of future performance. This information does not take into account your investment objectives, financial situation or particular needs. Before making any investment decision, you should obtain and carefully consider the PDS, having regard to your investment objectives, financial situation and particular needs.