PetersMacGregor
GLOBAL FUND

June 2017

Fund Facts

Portfolio Managers	Wayne Peters Michael Haddad
Structure	Global Equity Fund $AUD unhedged
Inception Date	10 September 2004
Fund Size	A$164million
Recommended Investment Timeframe	5 years plus
Distributions	Annual, 30 June
Management Fee[1]	1.35% p.a.
Performance Fee	Nil
Buy / Sell Spread	0.10%/0.10%
Benchmark	Unaware

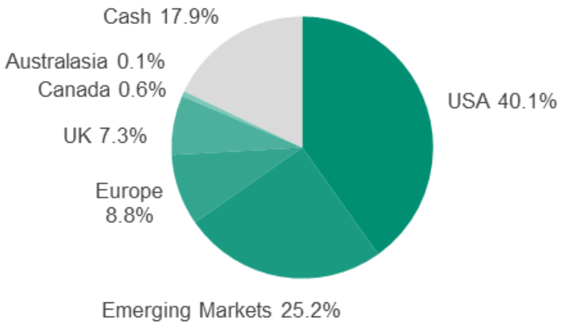
Top Holdings

Stock	Sectors
Berkshire Hathaway	Multi-sector Holdings
Fairfax Financial	Multi-line Insurance
Fairfax India	Commercial Services
Howard Hughes	Real Estate
JD.com	Internet Retail
Liberty Global	Cable
Liberty LiLAC	Cable
Liberty SiriusXM	Satellite Radio
NVR	Homebuilding
Wells Fargo	Diversified Banks

Fund Features

Investment Style	Value
Portfolio Composition	15-30 stocks, 0-30% cash

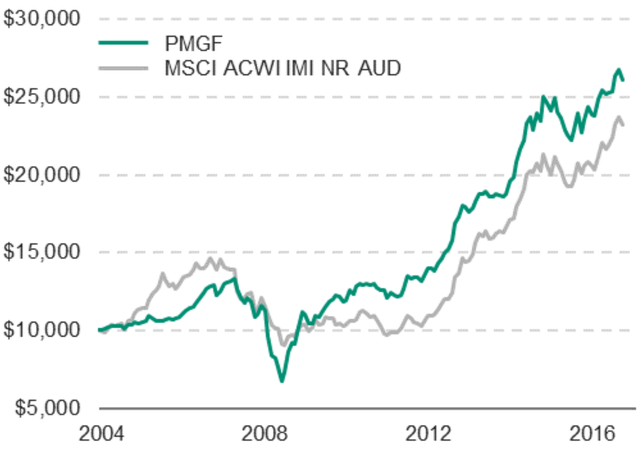
Geographical Exposure by Revenue[2]



Fund Performance[3]

	Fund %	Index %[4]	Excess %
1 month	-2.46	-2.37	-0.09
3 months	2.86	3.68	-0.82
1 year	14.85	15.53	-0.68
3 years (p.a.)	11.83	12.37	-0.54
5 years (p.a.)	14.30	17.36	-3.06
7 years (p.a.)	11.36	12.19	-0.83
10 years (p.a.)	7.30	5.00	2.30
Since inception (p.a.)	7.78	6.78	1.00
Total return since inception	161.19	131.87	29.32

Growth of $10,000 Since Inception



[1] *All fees are inclusive of the net effect of GST*

[2] *Peters MacGregor may on occasion, hedge against movements in the Australian dollar and other currency exchange rates, but the default position is to remain unhedged. Regional revenue breakdowns are approximations.*

[3] *Performance figures are calculated using exit unit price to exit unit price for the given period. Intra year performance figures are unaudited. The returns are net of management fees. They do not include franking credits.*

[4] *MSCI ACWI IMI NR AUD*

Monthly Performance (%)

Financial Year	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	FYTD
2004-05			0.16	0.95	1.08	0.57	-0.36	0.51	0.06	-1.70	2.02	0.63	**3.94**
2005-06	1.02	-0.26	0.33	0.93	3.08	-1.76	-1.17	0.12	0.14	0.14	0.83	-0.32	**3.02**
2006-07	0.58	0.94	1.95	1.66	1.60	0.42	2.48	2.54	3.00	1.86	1.05	0.76	**20.52**
2007-08	-4.98	1.82	3.93	0.89	0.29	1.71	-5.42	-4.54	-2.49	2.70	-2.01	-8.03	**-15.66**
2008-09	1.55	5.28	-2.89	-14.76	-12.58	-2.26	-7.60	-11.11	8.79	17.70	6.27	-0.41	**-15.83**
2009-10	11.63	9.30	-1.28	-5.05	-0.18	4.37	-0.32	3.42	2.31	2.97	1.64	2.08	**34.26**
2010-11	-0.81	-2.86	0.87	5.45	-1.95	4.17	0.87	-0.25	0.33	-0.30	0.61	-1.88	**4.02**
2011-12	-1.50	-0.39	-3.66	2.59	-1.32	-0.83	1.11	3.07	6.64	-0.95	0.22	0.01	**4.67**
2012-13	-1.44	3.56	2.53	-0.09	-1.01	3.58	1.96	2.33	1.84	3.37	6.90	2.33	**28.83**
2013-14	4.41	-0.49	-1.71	1.38	2.26	2.74	0.02	0.86	-1.83	-0.05	1.27	-0.69	**8.28**
2014-15	-0.37	0.76	4.46	1.21	4.90	4.21	2.61	4.87	1.82	-3.59	4.52	-1.88	**25.70**
2015-16	6.53	-1.39	-2.03	3.38	-3.75	-1.70	-3.25	-1.29	-1.65	3.01	4.95	-5.20	**-3.09**
2016-17	3.69	3.37	-2.09	-0.44	4.59	2.25	-0.74	0.10	0.57	3.87	1.52	-2.46	14.85

This document is provided for investors in the Peters MacGregor Global Fund (ARSN 110 619 559) and is not intended to provide advice. While all care has been taken in the preparation of this report (using sources believed to be reliable and accurate), Peters MacGregor Capital Management Limited (ABN 077 087 181 600, AFSL 225984), its officers, employees, agents and associated entities accept no responsibility for and will not be liable in respect of any loss or damage suffered by any person in connection with this, other than under law, which cannot be excluded. You should seek your own financial and taxation advice before dealing with your investment. This report has been prepared without taking into account your investment objectives, financial situation or particular needs. Before investing, or retaining an investment, in the Fund you should read the PDS dated 14 June 2016 and consider whether the Fund is appropriate having regard to those matters. A copy of the PDS is available at petersmacgregor.com. Past performance should not be taken as an indication of future performance.

Introduction

The Peters MacGregor Global Fund increased 2.9% during the quarter, trailing a strong 3.7% return by the MSCI ACWI IMI Net Return AUD index. For the financial year, the returns were 14.9%. A strong absolute return, considering the portfolio's cash weighting and the slight headwind from the higher Australian dollar.

It's also a reminder that when markets are gripped by fear, like they were early in 2016 due mainly to slowing growth in China, you need to feel the fear and buy anyway.

Our job is not to predict swings in the economic environment, but rather to own businesses at prices that compensate us for all manner of risks both macro and micro, current and future.

You can't have good news and cheap prices, and low valuations reduce risk and increase potential returns despite how it feels when share prices are falling. If you want different returns from the market, you need to do something different.

That contrarian instinct will be more valuable over the next five to ten years than it has been since the GFC, as low interest rates have increased asset values worldwide. When this situation changes, stock selection will become much more important.

Note that from July the benchmark index will change to the MSCI ACWI Net Return AUD index. Though it makes little difference when comparing our performance, it's a more accurate benchmark as we do not invest in global micro-cap companies (the previous index covered companies with market values less than approximately US$220m).

The portfolio currently owns 22 companies and cash constitutes 18% of the portfolio.

General commentary

If someone was going to ring a bell signalling the markets were at or near a peak, it would probably sound like Argentina's recently announced 100-year bond issue yielding 8%. Argentina has defaulted eight times in the past 200 years. At such times, we repeat Raymond DeVoe Jr's warning that '**More money has been lost reaching for yield than at the point of a gun**.'

The US has increased its official cash rate three times since December 2015, from 0.5% to 1.25%. While economic growth will be restrained by the country's high debt levels, there were good reasons to move.

Although the US is stuck with a large pool of permanently unemployed, official unemployment is low and banks have fixed their balance sheets following the housing bust and subsequent litigation.

In contrast, the UK reduced its official cash rate to 0.25% immediately following the Brexit vote. Canada's 0.5% cash rate is back at its emergency-low during the GFC, and the European Central Bank (ECB) has held the official cash rate at zero or below since 2012. It's little wonder asset values have increased so much since the GFC.

If you were long stocks since the GFC you've likely done very well. You haven't needed alpha (i.e. outperformance over the index) either, simply owning the market (particularly the US market) has provided excellent absolute returns. This explains the performance and subsequent popularity of passive products, such as index funds and ETFs.

Higher interest rates signal a major change, though. A recent speech by ECB President Mario Draghi was heard to suggest European interest rates could start increasing next year. Canada and the UK then surprised markets suggesting interest rates could also rise there. The odds of an imminent rate rise in Australia has also increased dramatically from virtually zero a few weeks back.

While we don't expect interest rates to increase by much, or rapidly, the implications for investors vary between continents. Higher Australian interest rates are a major threat to the housing market and our major banks. Ditto for Canada.

In contrast, European financials have been battle-tested three times in the past nine years. The GFC; 2011 when European bond yields increased rapidly into the teens; and last year when the market questioned Deutsche Bank's 'toxic' derivatives book and weak profitability.

Today, most European financials have strong capital ratios, falling bad debts, increasing profits and dividends, and will benefit in the same way US banks have over the past year once the market anticipates higher interest rates.

Despite how it might feel, it's the safest time in twelve years to buy European financials. Things are improving daily and valuations remain attractive.

Low interest rates have lifted all boats, but most assets don't offer a margin of safety at current valuations. To keep earning decent returns safely we must be choosy and avoid areas of overvaluation.

Despite single-digit price-to-earnings ratios, stocks linked to the US car industry look particularly vulnerable. Second hand car prices are falling below residual values, which augurs poorly for new car sales, refinancing and one of America's largest industries.

We're finding opportunities where reversion to the mean is working in our favour and, as always, in dominant businesses where we disagree with the market's view of their long-term earnings power.

Even in an expensive market these opportunities exist, as you can see from the many companies that have performed well even if you bought them at their highs prior to the GFC.

We look forward to the opportunities that will be created by more volatility as markets adjust to higher interest rates, and sleep comfortably knowing that each day highly motivated, honest and intelligent management teams are working hard to increase the value of our businesses.

Portfolio commentary

India

Much is written about India. The size of the population (1.3b and growing 1.9% p.a.); the demographics (50% of the population is under 25 and 65% are below 35); and a median income per capita of US$616 p.a. The potential for investors is obvious.

Wayne's recent visit to Mumbai hammered home this opportunity; keep in mind Mumbai's population alone is equal to Australia's. But more importantly, the country finally has a mostly rational and pragmatic government led by Narendra Modi, who has announced four very significant policies.

1. In a very clear message that corruption must be stamped out, taking the 500 and 1,000 rupee bank notes (roughly A$10 & A$20) out of circulation last year immediately shrunk the black market and reduced bribery.

2. Unparalleled anywhere else, India has introduced the world's largest biometric ID system called Aadhaar with 1.2bn residents enrolled. This will eliminate duplicate and fake identities, reduce fraud and corruption, facilitate the opening of bank accounts, which eventually leads to increasing credit and economic activity. This move alone will have unfathomable benefits for the country.

3. The introduction of a Goods and Services Tax. Tax revenues will finally be collected from a broad base, which can be directed to social systems (the country doesn't have a national health care system) and desperately needed infrastructure. Government tax revenue in India is only about 12% of GDP, one of the lowest in the world, compared to about 33% in Australia.

4. Housing for All by 2022 Mission. This is an ambitious plan, to grossly understate it. Again though, the implications and opportunities are enormous.

Apart from meeting the CEOs or CFOs of fourteen companies, meeting and hearing presentations by Dr Jaishankar, the Foreign Secretary, Mr Sinha, the Minister of Civil Aviation, Mr Prabhu, the Minister for Railways and Mr Kalyanaraman, head of the National Housing Bank synthesised the government's priorities and expected impact.

FAIRFAX INDIA
HOLDINGS CORPORATION

While providing several targets to research further, the trip culminated in our first investment in India. Ironically, it's listed in Canada; **Fairfax India Holdings Corporation**.

Fairfax India resembles a listed investment company (LIC), as it's a ready-made portfolio of Indian businesses providing a broad exposure to deals we could never get access to on the listed market.

Fairfax India is chaired by Prem Watsa, who is the founder and chairman of **Fairfax Financial**, which we also own. Fairfax India pays fees to Fairfax Financial and as we write it trades at a 28% premium to its last reported net asset value (NAV).

Normally you should buy LICs at a discount to NAV adjusted for fees, but we believe the current reported NAV significantly undervalues the company's investments. We also expect rapid growth as India grows and Modi's policies reshape the country.

Image: Bangalore International Airport , one of Fairfax India's largest investments

The company's key investments include a 48% share of the Bangalore International Airport, 30% of specialty PVC company Sanmar, which has the potential to increase in value many times over, and 27% of financial services company IIFL.

While partnering with an honest and capable management team with the ability to compound our capital at high rates of return for decades is the key attractions, owning assets that aren't correlated with the US and Europe also adds diversification.

JD.COM 京东

JD.com is conveniently described as the *Amazon of China*, albeit there are some major differences. But its growth rates aren't one of them.

To celebrate the company's anniversary, JD.com's '6.18' sales event offered discounts for the first 18 days of June. Transaction volumes of US$17.6b increased 50% from the previous year, with 80% of sales delivered the same or next day due to its unrivalled logistics network.

JD.com is often derided unfairly as an Amazon clone. As China doesn't have an established delivery network supplied by the likes of America's FedEx and UPS, JD.com founder and chief Richard Liu decided to become a leader in delivery to offer the best internet shopping experience despite the massive investment in warehouses and staff required.

That was an intelligent, contrarian decision in a world that covets high free-cashflow businesses that consistently report high return on equity. These types of short-term pain for long-term gain are exactly what we expect of the managers we invest in.

JD.COM 京东
JDRONE

Image: A JD Drone in flight

Ten years on and now **Amazon** is mimicking JD, having assembled its own trucking fleet. JD, meanwhile, has successfully executed thousands of drone test flights and will likely be the first major internet retailer to offer large scale drone delivery. This will also help reduce delivery times to China's regional areas.

While the 58% increase in JD's share price over the past year salutes its progress, we believe the company's competitive advantages are still under appreciated and intend to remain long-term owners.

Tencent 腾讯

Tencent is a $350bn Chinese company that you've probably never heard of. It's best known for its free WeChat mobile messenger service, but today **Facebook** is desperately trying to replicate WeChat, which is like Facebook, PayPal, Uber, Yelp, and Expedia rolled into one.

WeChat has more than 900m accounts, with the clear majority in China. Remarkably, half of those users reportedly spend more than four hours per day on the app. Tencent dominates the Chinese gaming industry with a 50% share, compared to second-placed **NetEase's** 20% share, making over half its profit from PC and online games.

Surprisingly, given the hold the company has over people’s time, only 15% of revenue comes from advertising. Tencent only publishes one advertisement per day per user on its Facebook-equivalent service Moments, compared to the 40-50 ads suffocating North American Facebook users daily and slightly less annoying 20-25 that Asian Facebook users receive.

It also has a rapidly growing payments business, like PayPal except it efficiently handles tiny transactions that are often cost prohibitive in the west. Again, there is huge potential in this business due to the app’s huge base of users.

In the first quarter this year Tencent’s earnings increased 58%, which explains why we felt comfortable paying 37x earnings. With earnings growing so quickly the multiple should fall quickly, too.

China's technology industry used to be ridiculed as a copycat of Silicon Valley companies, but now it’s an innovator. Given the enormous cashflows these companies produce and the lack of domestic competition (China encourages national champions), the days of starting a competitive technology company from your basement, à la Steve Jobs and Steve Wozniak of Apple fame, appear to be limited.

Liberty SiriusXM Group

On 9 June, America’s only satellite radio subscription service **SiriusXM** announced a $480m investment in music streaming company Pandora. SiriusXM only offers a subscription based product, while Pandora is a leader in advertising-supported streaming.

SiriusXM will likely offer an ad-supported service eventually, and this investment ensures a healthy working relationship with SiriusXM gaining three seats on Pandora's board.

During our annual pilgrimage to Omaha in May, we met with **Pandora** and were extremely impressed with the song selection algorithms they’ve developed for their 80m-strong army of listeners (SiriusXM has ~30m paying subscribers).

As SiriusXM soon starts rolling out internet-enabled car radios with two-way communication, Pandora's technology will help improve SiriusXM's listener experience. In addition to SiriusXM’s unique content, it will further insulate the service from less convenient and inferior, but less expensive competitors.

Royal Bank of Scotland

During the quarter, we also added up and coming UK retail bank **Metro Bank**, which we explain in detail below. Our analysis of Metro also suggested we sell our small stake in **Royal Bank of Scotland** (RBS) following the rebound in its share price since the Brexit vote.

RBS was supposed to be a more complicated version of **Lloyds Bank**, which we still own (note during the quarter the UK Treasury sold the remaining Lloyds shares it owned).

A back-to-basics turnaround that would shrink the number of countries the company operates in from around 30 to less than 10. In turn, the highly profitable UK retail franchise would re-emerge in all its glory.

As with many turnarounds, progress has been slow. Management’s plans have been thwarted by regulators and litigation, and financial targets have been lowered and extended several times. Following the recent increase in the company’s share price, and considering management’s latest financial projections for 2020, the returns weren’t high enough to hold on.

MEDIOBANCA

At the end of June two Italian banks were euthanised. Instead of creating panic, it was done in an orderly manner and depositors’ savings were preserved. The Italian Government kept the bad debts, which will eventually be sold at cents in the dollar, while well-managed Italian bank **Intesa Sanpaolo** paid the symbolic figure of €1 for the good loans.

The wind up of two troubled Italian banks, which follows last year's multi-billion capital raisings by large German and Italian banks **Deutsche Bank** and **UniCredit Banca**, has made the European banking system the safest it's been for at least a dozen years.

Balance sheets are either in good shape or improving, bad debts are falling, the PIIGS economies that panicked markets in 2011 are recovering, property prices are increasing, the fall in the Euro is stimulating European exports, and bank earnings and dividends are increasing.

You can commonly find high quality banks trading at book value or less, which mainly reflects the impact negative interest rates are having on bank profit margins, rather than bad debt issues. We explained the investment case for **ING Groep** in the prior quarter, but more recently we've added **Mediobanca**, Italy's version of Macquarie Group.

It trades at 0.8x tangible book value, it never raised capital during the GFC and pays a 3% dividend. Return on tangible equity is expected to increase to 10% by 2019.

Mediobanca will benefit from any increase in corporate activity in the short-term, such as the Government's sales of loan portfolios. But longer-term earnings and dividend growth will reflect interest rate movements, and the performance of its online retail bank CheBanca! and promising asset management business.

Conclusion

Many investors are currently torn between the intoxicating mix of low interest rates and rising markets and a constant flow of media articles predicting the next economic downturn or financial apocalypse. But as research shows repeatedly, investors that try to time market fluctuations perform much worse than the funds they invest in.

While sitting pat and riding out periods of volatility is usually the best bet, confidence comes from what you're invested in. And owning an index fund or ETF based on a broad index of US stocks currently priced to deliver lousy outcomes should be causing heartburn.

Speaking of which, **McDonald's** price-to-earnings ratio has doubled from 13 to 27 since the GFC despite its earnings going nowhere. Why would you pay such an exorbitant price for a series of cashflows that aren't growing in the good times, and face increasing competition as food habits change?

This is just one example of a popular and familiar stock that's misconstrued as safe in our view. The company's share price could easily justify a 30% drop in its share price before reflecting fair value.

ETFs and index funds are filled with these types of stocks, as they buy based on demand and not value. But eventually value always matters.

You currently own a select, diversified portfolio of first class businesses run by entrepreneurial managers trading at prices that offer a margin of safety, and we look forward to adding more names over time.

Please don't hesitate to call if you have any questions about the portfolio.

Stock in focus: Metro Bank

METRO BANK

Metro Bank is the new kid on a UK retail banking scene plagued with customers fed up by lousy treatment from the largely unchallenged oligopoly of **Barclays, HSBC, Lloyds Bank** and **Royal Bank of Scotland**.

Metro Bank first opened its doors in the summer of 2010, and was the first bank to receive a UK banking license in over 150 years. Metro currently has around 50 branches, 1m accounts and £10bn of deposits.

On a current annual run rate of slightly less than 20 new branch openings, Metro would have a network of between 200 and 250 branches by 2027. That means deposits could increase ten-fold for a 4% market share.

Provided the branches meet our profit targets, and we adjust for a couple of capital raisings along the way that we may participate in, an investment at the current price has the potential to triple or more over the next decade.

Back to the future

Metro is not a technological disruptor, as you might expect. Instead, Metro offers old fashioned service in branches that cater for kids and pets with coin counters and doggy treats.

The CEO and co-founder is Craig Donaldson, who has a long history working for UK retail banks, including Barclays and senior roles at Royal Bank of Scotland (RBS). His experience at RBS was pivotal, particularly around the time of the GFC. He derided the way customers were treated, and his plan to build a better bank was scrapped.

Fortunately, an industry veteran named Vernon Hill tapped Donaldson to implement the plan with him. Hill is lauded within the US banking industry for his remarkable stint founding and leading US bank Commerce Bancorp from 1973 to 2007. Over three decades Commerce Bancorp produced a 23% annualised return for shareholders.

Hill and Donaldson are following the same playbook at Metro as Hill did at Commerce Bancorp, which is solely based on customer convenience. To prove this is more than a slogan, every store is open seven days a week and from 8am–8pm on weekdays. No need to book an appointment for later in the week to open an account (like our mystery shopping exercise required at rival banks), just walk in at a time that suits you.

As the company only has one brand, and doesn't have hundreds of legacy IT systems that need to be integrated every time there is a major software change, you can open an account within 15 minutes and walk out with new bank cards. Metro also avoids slow and inflexible batch processing, instead its systems operate in real time. The speed of service this delivers following a lost card, for example, is like night and day compared to the big UK banks. It also reduces costs. Metro's new mobile app cost £8.4m to build, while RBS reportedly spent £120m. Up to 80% of branch rental costs are also covered by offering safety deposit boxes, which provides handy cashflow to maintain the pace of new branch openings.

A familiar landscape

The UK banking industry is much like Australia's, with the 'Big Four' banks dominating the market. Over 90% of competition in business banking comes from five players and over 80% in personal banking comes from six players. As you'd expect from such a consolidated market, it's highly profitable with return on equity ratios like Australia's. That's more impressive considering the impact the GFC had on British banks.

The key challenge for Metro is to increase the amount of deposits. Once a customer opens a deposit account, provided they feel valued as a customer, they typically use more services, such as taking out a home loan. As Metro doesn't use financial incentives to acquire customers like its rivals, it needs to maintain its unrivalled customer service so that word-of-mouth spreads.

Image: Metro Bank's flagship branch in Holborn

The company is aiming to open nearly 20 new branches per year, so they need to increase their profitability relatively quickly otherwise the bank will need to raise more money earlier or slow its growth plans.

It usually takes around 18 months for a store to become profitable, so you need to consider this when you analyse the bank's financials. While some ratios match the large, mature banks, Metro's reported profitability will be encumbered by immature stores for years to come. The key point is that Metro's reported earnings will not reflect its intrinsic value provided each new branch meets the company's profitability hurdles.

Fund managers are obliged to warn potential investors that past returns may not be indicative of future returns. But when an industry veteran of Vernon Hill's calibre joins forces with some notable investors, entrepreneurs and a highly motivated 45-year old CEO with decades of experience working in the senior ranks of the company's rivals, and decades ahead to grow the business, we believe history can repeat.

Further reading

- *Demostration of robotics used in one of JD.com's distribution centers*
  https://youtu.be/futkHNni3Es
- *March 2017 quarterly report*
  https://petersmacgregor.com/wp-content/uploads/2015/03/PMGF-Mar-2017-Quarterly-Report.pdf
- *Metro Bank boss Craig Donaldson is the man making banks nicer*
  http://www.standard.co.uk/business/metro-bank-boss-craig-donaldson-is-the-man-making-banks-nicer-a3381401.html