

# NAOS Absolute Opportunities Company (NAC)

NAOS

## MONTHLY INVESTMENT REPORT AND NTA UPDATE

JANUARY 2016

### KEY CHARACTERISTICS

#### 1. Global, Multi Asset Class Exposure

NAC invests in a range of equity, fixed income, currency and commodity securities both in Australia and Offshore, providing significant scope for capitalising on performance generating ideas. Key themes are identified and analysed for their impact at the security level, allowing the Investment Team to take advantage of fluctuations and mis-pricing situations on a cross sector, asset class and geographic basis.

#### 2. Positive Absolute Return & Income Generation Focus

The primary focus of the Company's investment strategy is the preservation of shareholders capital and the generation of meaningful absolute returns with a lower downside volatility than traditional equity focused managed funds. NAC offers investors the opportunity to derive a targeted minimum dividend of 4% p.a., which will be franked to the maximum extent possible.

#### 3. Focus on Meaningful Long Term Performance

Investment opportunities are assessed based on their potential to generate meaningful long term performance. Of primary consideration is quality rather than quantity, resulting in a concentrated portfolio of 'Best Ideas' (typically 0-30 holdings).

#### 4. Ability to Hold +100% in Cash

It has been proven that holding cash offers the 'best hedge' during times of crisis. Holding cash also provides flexibility and nimbleness to take advantage of security mispricing opportunities as and when they arise.

#### 5. Significant Alignment of Interests with Shareholders

NAOS employees/directors own a significant amount of shares and options in NAC. Staff are remunerated on the basis of the performance of the firm's investment vehicles through the application of a Performance Based Fee.

### Net Tangible Asset Value Breakdown as at 31<sup>st</sup> January 2016

Pre Tax NTA:	\$1.14
Post Tax & Pre Unrealised Gains NTA:	\$1.16
Post Tax NTA:	\$1.12

\*The above NTA calculations do not account for any potential dilution from the 21,492,500 NACO options that remain on issue (expiry 30<sup>th</sup> November 2016) and which are exercisable at \$1.00

### Portfolio Performance & Positioning

The Naos Absolute Opportunities Company returned -2.39% for the month of January. This compared favourably to the All Ordinaries Accumulation Index which fell by -5.38% over the same period.

Despite having outperformed global stock markets on a relative basis, we were unable to outperform our absolute benchmark for the month. The portfolio benefitted from contributions from the likes of a long position in Biostime International (China), our long USD position vs the AUD as well as long positions domestically in both JB Hi-Fi and BWX.

The main detractor for the month was Event Hospitality. EVT was one of the first positions we put into the fund and it has been an exceptional performer for us. The stock finished the month down 7.6% despite releasing no news to the market. EVT is a thinly traded stock and as such can be prone to irrational price swings. It is our intention to take advantage of these price swings as they happen.

	1 Month	3 Month	6 Month	1 Year	Inception (Nom.)
NAC Investment Portfolio Performance*	-2.39%	+9.17%	+13.53%	+22.40%	+24.37%
Benchmark (RBA Cash Rate + 250bps)	+0.40%	+1.18%	+2.37%	+4.85%	+6.08%
Relative Performance	-2.79%	+7.99%	+11.16%	+17.55%	+18.29%

S&P/ASX All Ordinaries Accumulation Index (XAOAI)	-5.38%	-3.54%	-8.82%	-4.69%	-2.54%
MSCI ACWI AC (Net, Dividends Reinvested, AUD Terms)	-3.61%	-7.88%	-8.83%	+7.86%	+11.91%

\*Investment Portfolio Performance is post all operating expenses, before fees and taxes.

### Market Insight

Stock markets around the world fell 6% in the first week of 2016 before most investors had returned from their Christmas break. The two major US indices, the Dow Jones Industrial Average and S&P 500, suffered their worst opening week in history. At the time of writing, the Dow is in correction territory, off nearly 11% from its May 2015 high, while the S&P 500 is a whisker away, down 9.3% from the highs also in May. The ASX200 has fared worse, down almost 17% from the high set in April 2015 and came close to entering a bear market during the month (a 20% fall constitutes a bear market).

The media has generally blamed two factors in particular, China and the falling price of oil. Most of the questions we are fielding have to do with one of the two, so we will address both.

Starting with China, on January 19<sup>th</sup> the Chinese GDP figures showed growth of 6.9% which is only marginally below their stated target of 7%. When compared with the rest

of the world, this is still a very high rate of growth, however the concern stems around the slowing *rate* of that growth. China is currently undergoing a significant transition from a capital spending led boom to a consumption driven boom. As a commodity producing nation, Australia was a significant beneficiary of the capital spending part of the equation. However we are now in a position where significantly less revenue is being earned from our commodity sales to China. We therefore need other areas of our economy to pick up that slack.

While the economic shift and the associated volatility that goes with it doesn't necessarily sound good for the Australian economy, there are still ways for us to participate in China's (still) high level of growth. A lot of that growth now is being driven by the consumer, particularly in areas such as retail sales and travel. Retail sales in China are up almost 11.5% versus this time last year and the latest stats of inbound tourism from China to Australia show growth of almost 11% from this time last year. There are numerous ways to play this growth on the ASX and they are sectors where we have solid weightings within the Australian allocation of our portfolio.

The next question to ask regarding China is 'what are the effects of a slowing China for global growth and in particular the US?' The USA's exposure to China is not as great as you might think. According to US national income accounts, only 0.7% of US profits are generated in China and Goldman Sachs research estimates that a 1% drop in China's GDP growth will have a 0.1% impact on US GDP from direct and indirect exposure. If you compare that to the GFC, the banking system in the US had a 39% exposure to US mortgages, hence why the shock was so great. Yes, there is always a risk of financial contagion from China to other countries, but we think this risk is being overplayed.

The second concern that both the media and some analysts are attributing to the market decline is the falling oil price. Howard Marks from Oaktree capital summed it up very well in a recent memo by pointing out that *"for net oil importers like the US, Europe, Japan and China, the drop we've seen in the price of oil is analogous to a multi-hundred-billion-dollar tax cut, adding to consumers' disposable income. It can also increase an importer nation's cost competitiveness."* Australia can also be added to that list of net importers. Mr Marks went on to say *"The one thing that is beyond doubt is that the impact of the fall in the price of oil is far from all bad."* We agree. While a rapid fall in the price of a key commodity can spread fear throughout markets, we don't feel the sell-off should be attributed to the oil price fall and we see the fall as a net benefit.

Following the global sell-off, the earnings yield on the ASX 200, the S&P 500 and the Stoxx Europe 600 are all above 6%. That's not cheap by historical standards, but still looks good relative to treasuries, cash and junk bonds. Despite the global volatility in share markets, the reduced prices are giving us more opportunity to deploy our funds. As Seth Klarman pointed out in 2008;

***" No one enjoys a sharp market downturn, with mark to market losses, growing panic and economic dislocation. Yet a downturn is a necessary precursor to an upturn; the seeds of recovery and eventually of substantial profit are sown amidst the carnage. The world is not ending; the great majority of people will remain employed and make their mortgage payments. Successful investing always requires a long term perspective; this has never been truer than at this moment in time"***

### Positive Stock Attribution Analysis (12<sup>th</sup> November 2014 to 31<sup>st</sup> January 2016)

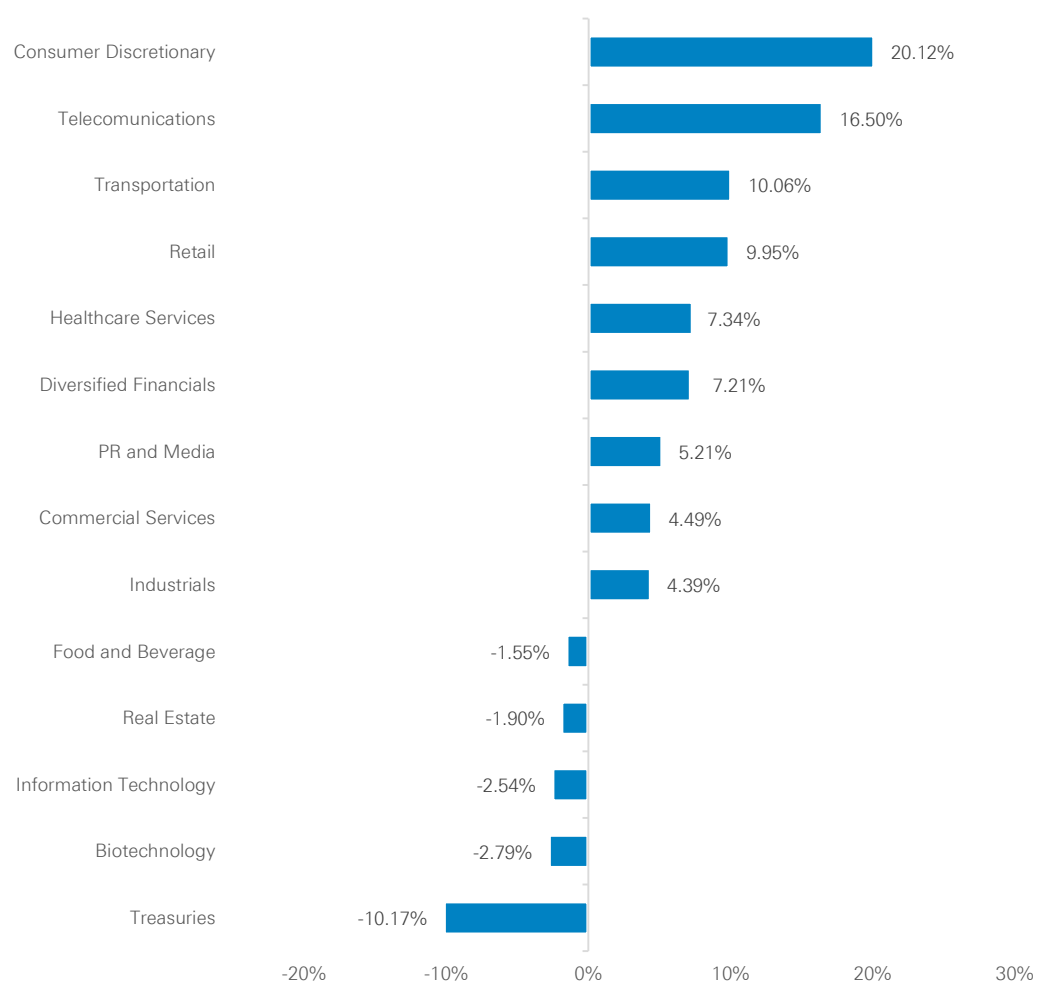
Below is a table listing the top positive contributors to NAC's total return since inception. The purpose of the table is to illustrate that the performance the investment team derive over time is not simply from one or two positions, but from a variety of positions, even with a concentrated portfolio of investments that is generally limited to 0-30 securities at any one time. Positions in the table below may have been held either as a long position or short position at any given point in time.

Investment	Contribution to Return (%NAV)	Investment	Contribution to Return (%NAV)
US Dollar	+7.03%	Macquarie Atlas Roads	+2.10%
Amalgamated Holdings Limited	+3.56%	Iselect Limited	+1.58%
Sirtex Medical Limited	+2.84%	Smart Group	+1.43%
Bellamy's Australia	+2.25%	BWX Limited	+1.12%

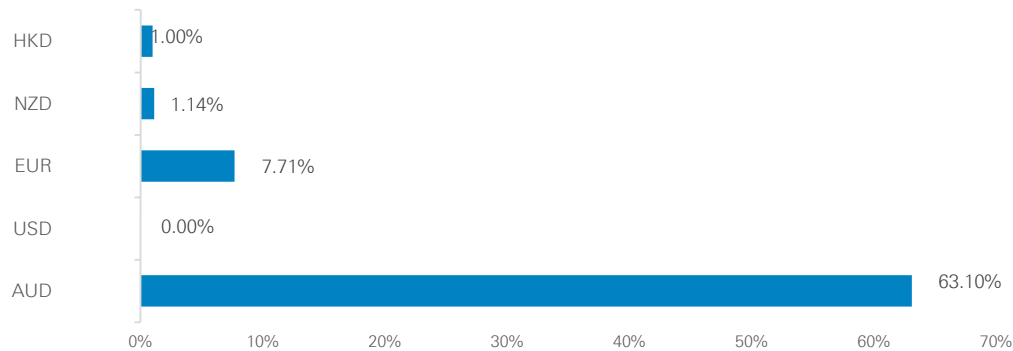
### Portfolio Analysis as at 31<sup>st</sup> January 2016

As at 31<sup>st</sup> January the portfolio comprised of 37 holdings, including 24 long equity positions, 9 short equity positions and 4 income instruments.

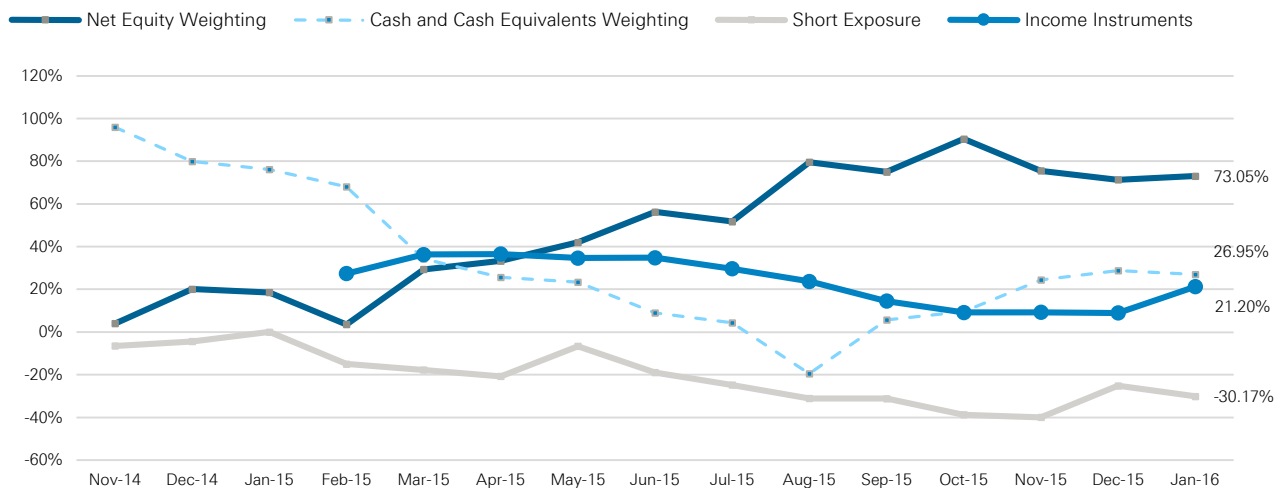
### Net Industry Exposure



### Net Portfolio Currency Exposure



### Net Equity Exposure



### Company Meetings

The NAOS investment philosophy is based around the belief that for a company to succeed and generate strong returns for shareholders it must be led by a motivated, proven and experienced management team. That is why the NAOS Investment Team has contact with many listed and unlisted companies across a wide range of industries and geographies. A selection of the unlisted and listed companies the team had contact with during the month of January were as follows:

- Qualcomm (QCOM US)
- DR Horton (DHI US)
- Pulte Group (PHM US)
- Paypal (PYPL US)
- Billabong (BBG AU)
- Xenith IP (XIP AU)
- Resmed (RMD AU)
- Medibank (MPL AU)
- Xero (XRO AU)
- Trilogy International (TIL NZ)
- RXP Ltd (RXP AU)
- Apple (AAPL US)

Portfolio Characteristics – Summary Data as at 31<sup>st</sup> January 2016

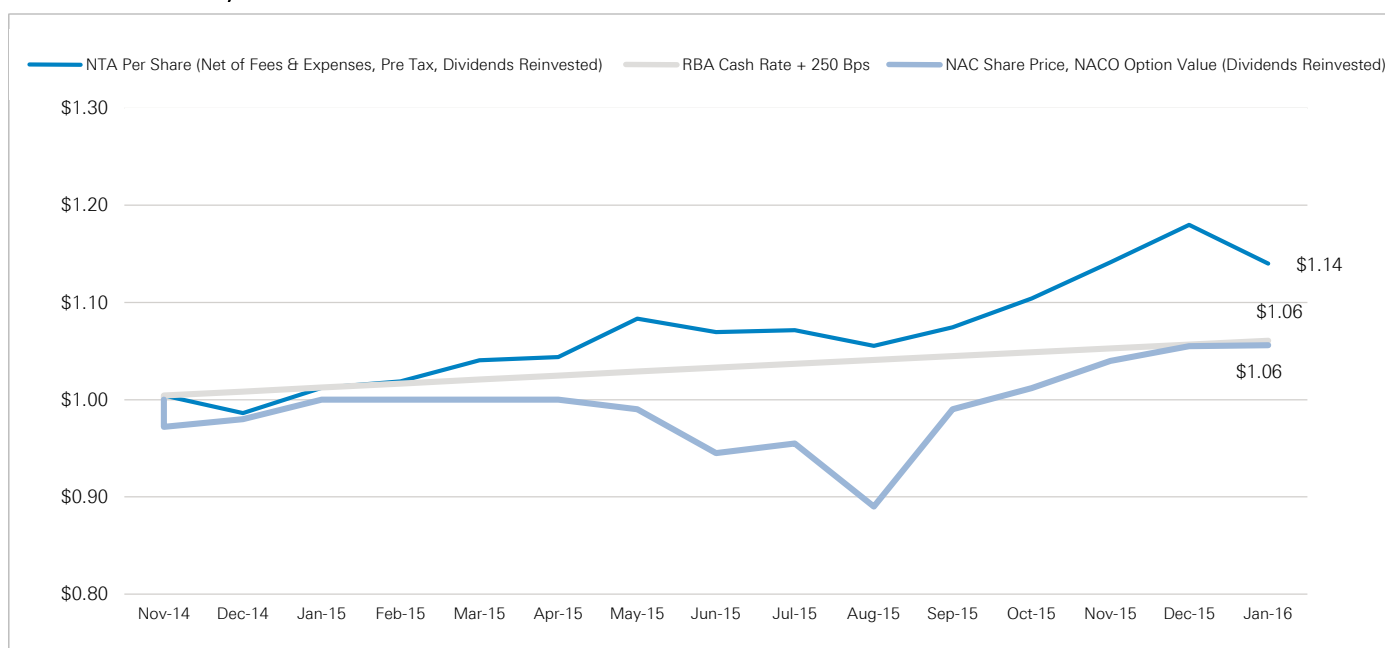
Total Number of Equity Holdings (Long & Short)	33
Total Number of Income/Debt Instruments*	4
Total Number of Holdings	37
Portfolio Weighted Market Capitalisation (AUD)	\$15.3bn
Percentage of Positive Months (NAC)	73%
Percentage of Positive Months (XAOAI)	47%
Standard Deviation of Returns (NAC)	9.40%
Standard Deviation of Returns (XAOAI)	13.72%
Correlation of Returns to XAOAI	46.88%
Sortino Ratio	7.13
Downside Deviation (NAC)	2.75%
Downside Deviation (XAOAI)	8.21%
Current Estimated Portfolio Beta	0.263

\*Listed and unlisted bonds, convertible notes, preference shares and other income securities – both domestic and international.

Capital Management - Summary Data as at 31<sup>st</sup> January 2016

Share Price	\$1.00
Share Price Discount to NTA (undiluted, pre tax)	14.00%
Historical Fully Franked Dividend Yield	4.00%
Historical Gross Dividend Yield	5.71%
Shares on Issues	21,507,500
Options on Issue	21,492,500
Directors Shareholding	1,480,203

NTA & Share Price Analysis



## Description of Statistical Terms/Glossary

**Portfolio Weighted Market Capitalisation** – The portfolio weight of each individual position multiplied by each companies respective market capitalisation.

**Standard Deviation of Returns** – A historical analysis of the volatility in monthly returns also known as historical volatility.

**Correlation of Returns** – A statistical measure of how two securities move in relation to each other. In this case the two securities are NAC and XAOAI. If the correlation is 1 then the two securities should have the same monthly returns and if the correlation is -1 and XAOAI had a return of -1.00% then NAC would be expected to have a return of +1.00%

**Sortino Ratio** – A modification of the Sharpe ratio that differentiates harmful volatility from general volatility by taking into account the standard deviation of negative asset returns, called downside deviation. A large Sortino may potentially indicate that there is a low probability of a large capital loss.

**Downside Deviation** - A measure of downside risk that focuses on returns that fall below a minimum threshold or minimum acceptable return (MAR). For our calculations, we use returns negative to zero for the calculation of portfolio downside deviation.

**Portfolio Beta** – A measure of the volatility, or systematic risk of a portfolio or security. A beta of 1 indicates a portfolio/security's price will move with the market. A beta of less than 1 indicated that a security/portfolio should be less volatile than the market.

**XAOAI** – All Ordinaries Accumulation Index

### Disclaimer:

This report has been prepared by NAOS Asset Management Limited. Information provided in this report is for general information purposes and must not be construed as investment advice. In preparing this report we have not taken into account the investment objectives, financial situation or needs of any particular investor. Past performance is not a reliable indicator of future performance. Before making an investment decision investors must read the offer documents and should seek their own financial product advice. Returns are compounded for periods greater than 12 months. The Investment Manager of the Company is NAOS Asset Management Limited (ABN 23 107 624 126, AFSL 273529). NAOS Address: Level 4 Domain House, 139 Macquarie Street Sydney NSW 2000. NAOS Telephone: 61 2 9947 2566

### CORPORATE DIRECTORY

#### Directors

David Rickards (Independent Chairman)  
Warwick Evans (Director)  
Sebastian Evans (Director)

#### Company Secretary

Julie Coventry

#### Investment Team

Sebastian Evans (Chief Investment Officer)  
Jeffrey Kim (Portfolio Manager)  
Robert Miller (Portfolio Manager)  
Ben Rundle (Portfolio Manager)

#### Chief Financial/Operating Officer

Richard Preedy

#### Business Development

Julia Stanistreet

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