Freehold Absolute Return Fund

Report for the month of February 2015

Fund Overview

The **Freehold Absolute Return Fund** takes long and short positions in listed securities exposed to assets such as office and industrial real estate, residential development, retail shopping centres, airports, ports, toll roads, rail and utilities.

Investment Objectives

- Generate returns of between 12 - 15% per annum over rolling three year periods
- Target portfolio volatility of less than 15%

Average Fund Statistics for February 2015

Number of positions:	10-15
Net Long:	~35%
Total Long Positions:	~55%
Total Short Positions:	~20%
Gross Exposure:	~75% (longs + shorts)

Fund Performance

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2013							0.52%	4.22%	2.79%	2.14%	1.93%	-0.19%
2014	0.57%	1.01%	1.21%	1.69%	1.71%	1.34%	1.80%	1.75%	0.36%	1.73%	0.81%	3.22%
2015	1.49%	1.11%										

Performance	
Rolling Quarter	5.92%
Rolling 12 month	22.50%
Since Inception	36.20%
Observed Daily Volatility	~4.6%

Attribution

Positive Contributors: Macquarie Atlas, APN Property Group, Aveo Group

Negative Contributors: Cromwell Group, Asciano, Dexus Property Group

Fund Profile

Trustee:	Freehold Capital Partners Pty Ltd, AFSL 344 188
Major Shareholders of the Trustee:	ASX listed Treasury Group (TRG) and Freehold Executives
Fund Managers:	Tim Hannon and Andrew Smith
Firm Funds Under Management:	AUD $296 million
Prime Broker and Custodian:	UBS AG
Administrator:	Citco Fund Services
Middle Office:	Mainstream BPO
Auditors and Tax:	PricewaterhouseCoopers
Legal:	DLA Piper Australia
Regulator:	Australian Securities and Investment Commission (ASIC)

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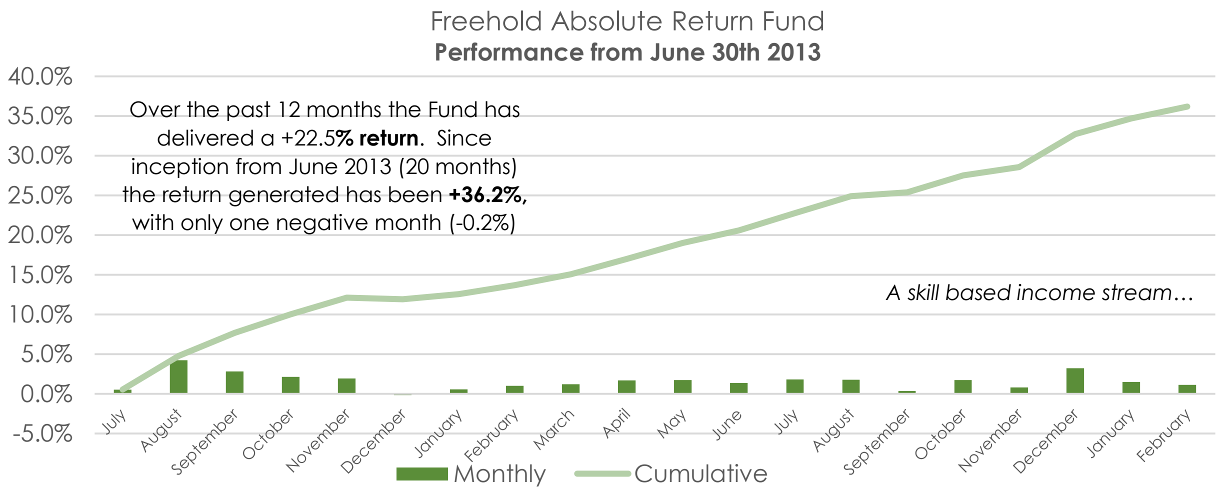
Fund Commentary

The Fund delivered a **+1.11% performance over February** as we witnessed continued strength in global real estate and infrastructure markets on the back of falling global interest rates.

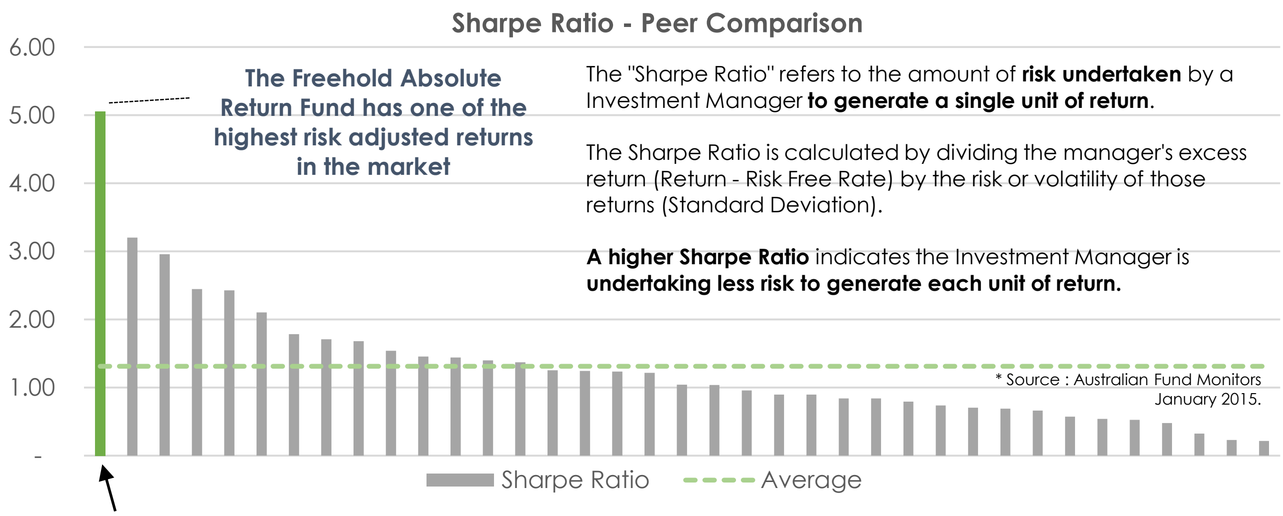
We are maintaining a **cautious and defensive stance** in the Fund given our concerns that the real estate and infrastructure sectors currently appear 'overheated'. We are observing a number of red flags, the chief of which is that some participants are disposing of a disciplined fundamental and valuation based approach, replacing it with a 'fear of missing out' attitude and spurious valuation techniques. Investors seem to be displaying some signs of behavioural bias, particularly "recency bias[1]" - **willing to extrapolate historically low interest rates into their valuations into perpetuity.**

Fund returns remain solid, with low levels of volatility…

The Fund continues to deliver **solid returns** with **low levels of volatility**, the chart below highlights this:



The Fund's 'Sharpe ratio' is market leading, but we expect it to decline back to more normalised levels over time…



The Freehold Absolute Return Fund Sharpe ratio is the green bar, peer funds are in grey

[1] Recency bias is a well-documented tendency to think that trends and patterns we observe in the recent past will continue in the future (see Miller and Campbell, 1959)

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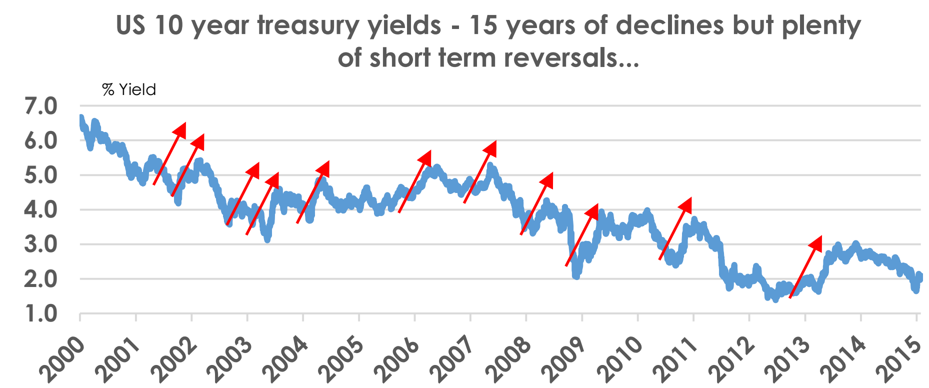
Market Commentary

It seems that the current over-riding consensus view is that **interest rates will continue to fall** globally**.** Security prices are being influenced by this 'macro factor' much more than they have been historically. More importantly, it seems many market participants are positioned for this 'certain scenario". **We argue falling rates is not a *fait accompli*. What would happen if interest rates actually rose instead of continuing to fall?**

The chart below highlights a clear trend of declining US interest rates, with the benchmark US 10 year treasury note yield falling from 6.5% in 2000 to 2.5% currently. What it also shows are some very **sharp reversals** in rates.

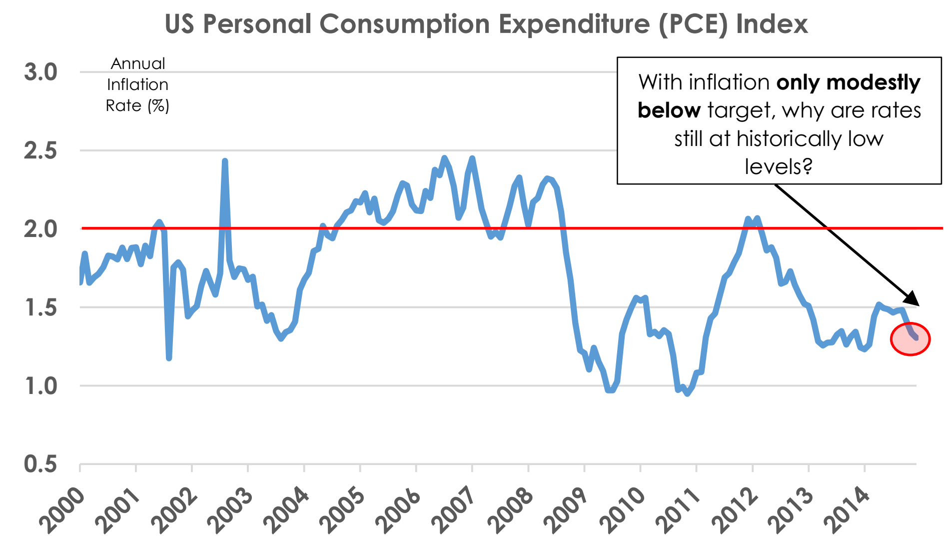


As can be seen from the chart on the left, there have been numerous **0.5% to 2.0% reversals** in bond yields over this time period.

We are highlighting this to illustrate that the market is currently positioned in the extreme for **falling rates,** seemingly oblivious to historical precedents that show **yield reversals occur quite frequently.**

When will rates start to rise?

The US Central Bank, the Federal Reserve (Fed), will likely begin increasing the primary rate they control, the Fed Funds rate[2], once they assess **inflation** returning to its 'target level'. The Fed evaluate changes in inflation by monitoring several different price indexes. A price index measures changes in the price of a group of goods and services[3].



The Fed often emphasises the price inflation measure for **personal consumption expenditures (PCE),** produced by the Department of Commerce, largely because this index **covers a wide range of household spending.**

The Fed judges that inflation at the rate of **two percent** (as measured by the annual change in this Index) is most consistent over the longer run with the Fed's mandate for **price stability and maximum employment**.

As can be seen from this chart on the left, the PCE index remains below the Fed target rate of 2%.

[2] The Fed Funds rate is the interest rate that banks charge one another on one-day loans of reserves, it is a very short term rate, Source: Advanced Macroeconomics, David Romer, Fourth Edition, 2012

[3] www.federalreserve.gov: Board of Governors of the Federal Reserve System, What is inflation and how does the Federal Reserve evaluate changes in the rate of inflation?

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> *"In my speeches as a governor of the Federal Reserve, one of my hardest tasks was to convince people of the fact that we do not know as much about money as people think"*
>
> **Sherman Maisel (1973) - American economist who served on the Board of Governors of the Federal Reserve System from 1965 to 1972**

Wage inflation

Whilst we have highlighted that the key inflation index is still below the Fed target of 2%, favoured **lead indicators** are pointing to inflation accelerating. One of the most important lead indicators is the **direction of wages growth** as this is the **major input** into inflation[4].

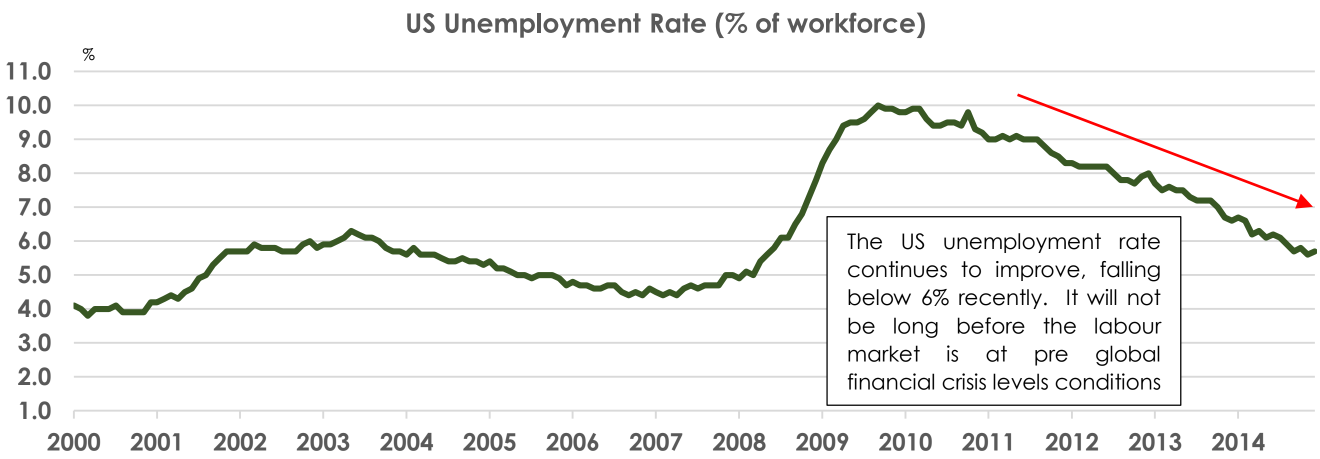
The other reason that wages data is important is that the current Chair of the Board of Governors of the Fed, Janet Yellen, seems to be more focused on the labour market than her predecessors. It is worth noting that the last Fed statement states that the economy had **"strong job gains"** recently[5]. **The two data series below certainly illustrate this.**

A well-known leading indicator for future jobs growth and wage inflation is the **US job openings survey**.

This lead indicator illustrates a robust recovery is underway.

Source:

Job Openings and Labor Turnover Survey (JOLTs), www.bls.gov



> *"I have no doubt that the United States would be better off if the Federal Reserve had never been established"*
>
> **Economist Milton Friedman, New York Daily News, 1981**

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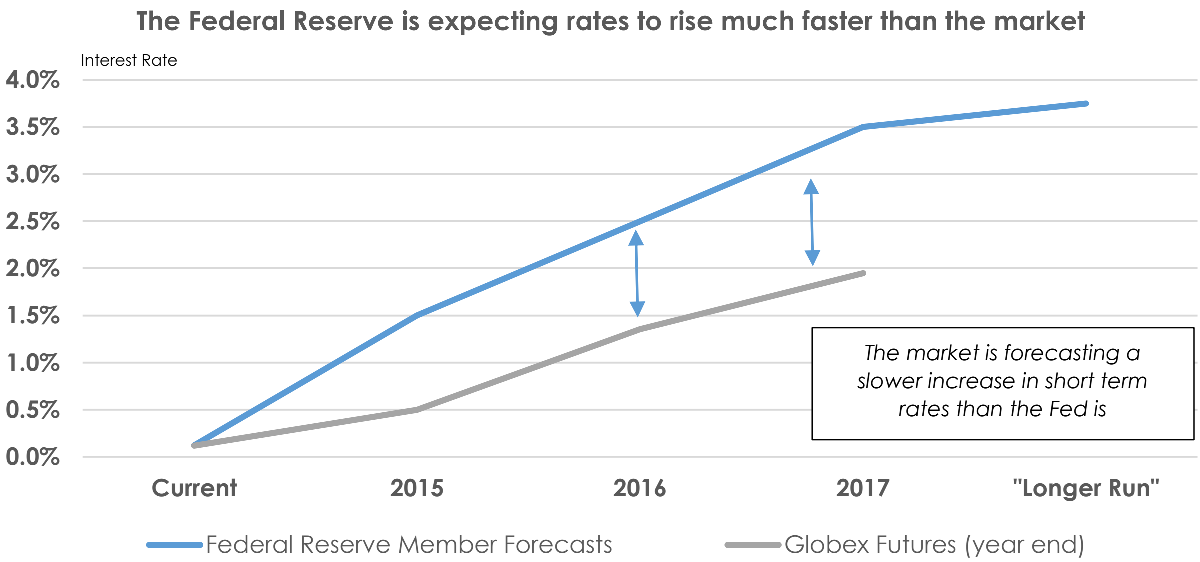
[4] As UBS highlight in a note called "What are the perils and prizes for corporates and financials when US yields rise", February 2015

[5] Source: Credit Suisse, US Economics Digest, 6th February 2015

Federal Reserve Board Members are forecasting higher short term rates than the market is…

The market is currently forecasting a slower rate hiking cycle than the Fed is suggesting will occur. The chart below highlights this[6]:

- The **blue line** in this chart is the **Fed forecast** for rate rises
- The **grey line** on this chart is the **market forecast** for rate rises (as priced by the futures market)



We conclude our review of short term rates by suggesting that the market **is currently positioned for lower rates,** but there are clear risks of rates rising more quickly than the market anticipates:

- **Lower oil prices** acting as a stimulus to US economic growth
- Lead indicators on the **wages inflation** front pointing to inflation rising to the Fed's target
- A Fed that is expecting rates to rise more quickly than the market is pricing

If short term rates rise, will long term rates rise?

If short term interest rates rise, it is highly likely **longer term interest rates rise.** The interest rate on long term bonds must equal the average of the interest rates on short term bonds over its lifetime.

"Long term interest rates depend on expectations of future short term interest rates[7]"

"Ten year yields can be thought of as an average of ten consecutive one year forward rates[8]"

An unanticipated rise in long term yields is important for the pricing of all assets as the long term government yield (risk free rate) is used as a key input into the valuation of cash flows derived from an asset. Also importantly, if US long term yields rise, it is highly likely that Australian long term yields will rise.

[6] Source: Advanced Macroeconomics, David Romer, Fourth Edition, 2012

[7] Monetary Theory and Policy, Carl Walsh, Third Edition, 2010

[8] Testimony from Alan Greenspan, a previous Chairman of the Federal Reserve, 2005,

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What if we do see a situation where there are unanticipated rises in US interest rates?

If long term rates rise unexpectedly, any beneficiary of the well-publicised 'yield trade' will probably underperform materially. We will likely see REITs, utilities, infrastructure and telecommunications sectors experience a correction.

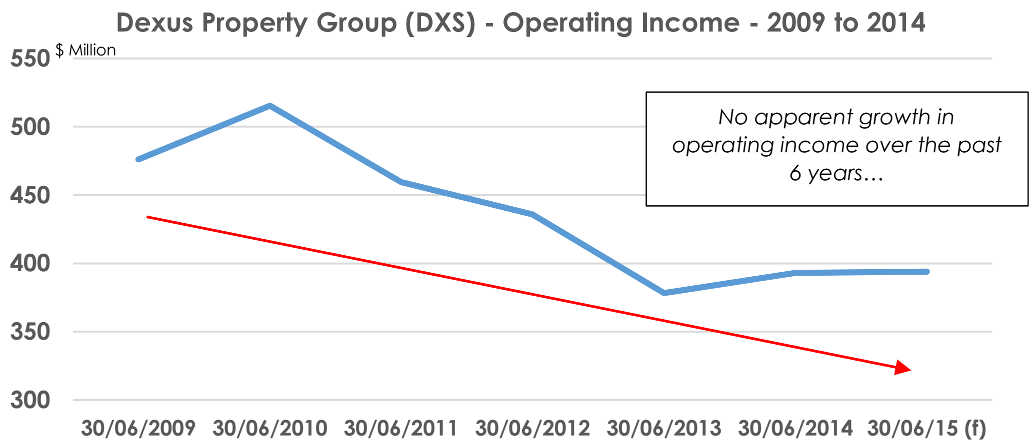
"We feel everything with yield has been pretty crazily priced, resulting in a lot of no-growth, 20X P/E utility stocks"

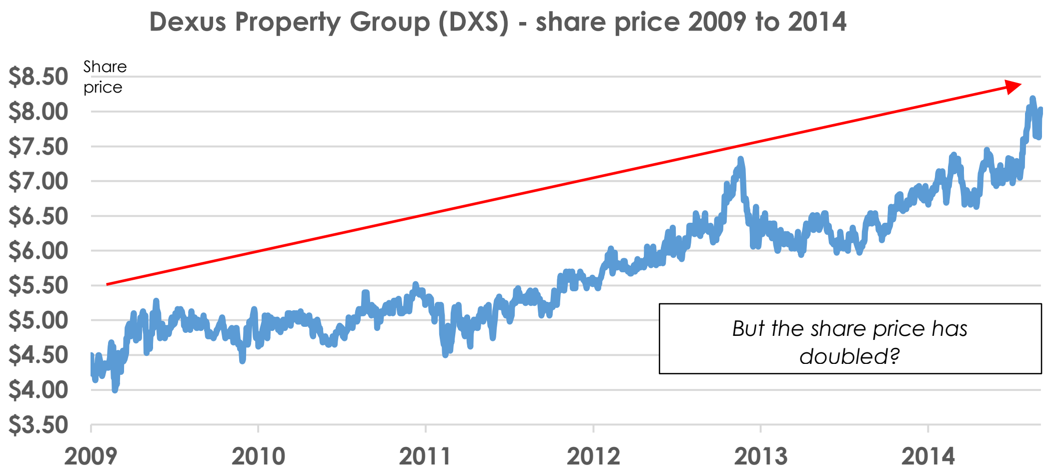
Brian Lancaster, Clayton Partners, US based Fund Manager

Conversely, there is the potential for more **cyclical sectors to outperform** (for example energy and capital goods[9]) as central bank actions point to higher expectations of future economic growth.

"At times when interest rates are unusually low, however, investors are likely to find very high multiples being applied to share prices. Investors who pay these multiples are dependent on interest rates remaining low, but no one can be certain that they will"[10]

Seth Klarman, Margin of Safety and founder of Baupost Group, a private investment partnership





Source: Bloomberg

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[9] We exclude the historically cyclical materials sector due to the likelihood of a deep and prolonged downturn as the composition of China's economic growth rebalances away from fixed asset investment

[10] Source: Mr John Garrett, Moelis and Co.

Incentives are being used to make things look better than they are…

The commercial real estate industry is curious in its **use of incentives** to encourage tenants to sign up for leases.

We highlight that real estate investors should be aware of how incentives can be used to mask degradation of asset fundamentals.

What are incentives?

In simple terms, a landlord can offer a potential tenant the following incentives:

- **Rent free** periods – the tenant does not pay rent for a determined length of time
- **Reduced rent** period – the tenant does not pay full rent for a determined length of time
- **Contribution to fit out** (carpets, walls, desks, paintings, conference rooms) – the landlord gives the tenant money to pay for tenant improvements

What is the impact?

Whilst there is nothing fundamentally wrong with offering incentives, the problem can stem from the way real estate companies report their profit numbers. Some of them report a profit number that does not take into account the costs of incentives.

The below quote from the Property Council of Australia, whilst out of date, probably highlights how some real estate companies still think about accounting for incentives:

*"A **new threat** has emerged with a proposed accounting standard for lease incentives. The Australian Accounting Standards Board (AASB) wants property owners to **deduct the value of a lease incentive** from their rental income. Simply put, your bottom line will be reduced and distributions to unit or shareholders will diminish.*[11]*"*

The outcome of not deducting incentives from income is that real estate companies are paying a distribution that **is not fully cash covered**. The distribution is essentially being paid using debt or equity capital.

We have identified a number of REITs paying out more in distributions than they are making from their real estate assets. **We view this practice poorly.**

The other major reason that incentives are used in the industry is that they have a role to play in **preserving asset valuations**. Valuers will apply a capitalisation rate to 'headline rents', this capitalisation rate *should* take into account rent free periods and capital incentives, but it is imperfect. What we generally see is that headline rents are preserved by using incentives so that valuations for the real estate asset do not fall.

Conclusion

The key is to be aware that real estate companies use incentives to bolster occupancy and accounting income, to the detriment of cash flow and the balance sheet. Real estate companies should be valued on the cash flows generated **after incentives** have been made. When we value real estate companies, we value the **free cash flow** from the company, not accounting profits or distributions.

[11] Property Council of Australia website, 2010

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Stock of the month

Macquarie Atlas (MQA)

MQA is a global **toll road developer and operator**. It is the non-Australian assets that were spun out of the previously listed Macquarie Infrastructure Group (MIG) in early 2010.

Autoroutes Paris-Rhin-Rhone (APRR) is estimated to make up more than 90% of MQA's portfolio value. MQA owns a **20.1% stake** in this French toll road.

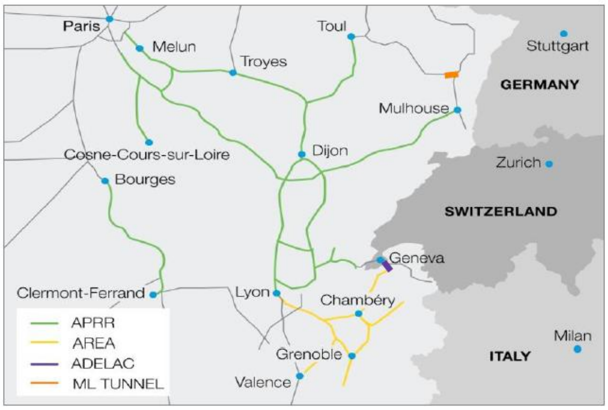
APRR comprises four concessions

APRR
Concession Expiry: 2032
Road Length: 1,840km

AREA
Concession Expiry: 2032
Road Length: 394km

ADELAC
Concession Expiry: 2060
Road Length: 19km

ML TUNNEL
Concession Expiry: 2068
Road Length: 11km



Source: Macquarie Atlas disclosure documents

The other 10% of the MQA valuation is comprised of three smaller assets:

- Dulles Greenway (USA - 50% owned) is a privately owned 14-mile toll road that connects Washington Dulles International Airport with Leesburg, Virginia.
- Chicago Skyway (USA – 22.5% owned) currently being divested
- Indiana (USA – 25% owned) currently being divested

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Flow of events

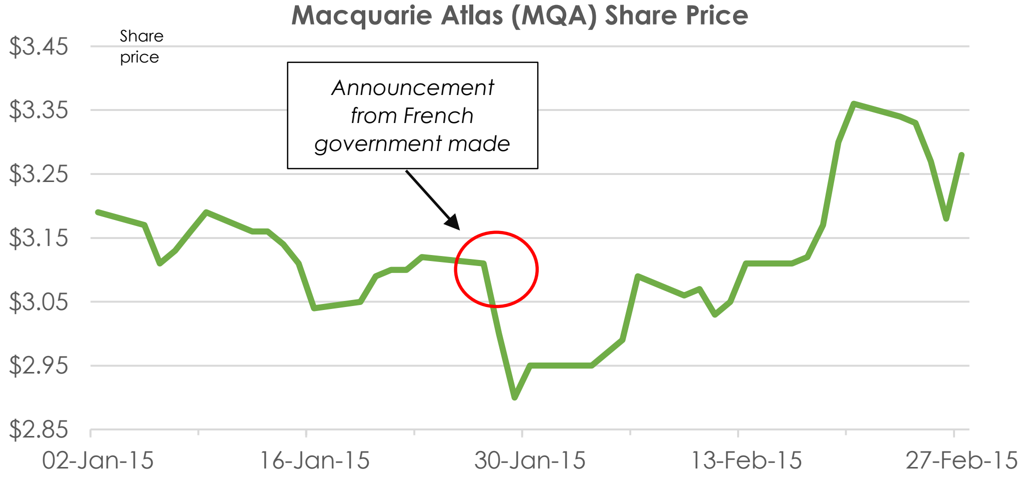
The opportunity arose in MQA on the back of a high degree of **political risk** being priced into the security

A press release dated 27 January 2015 was issued by the office of the French Prime Minister, Mr Manuel Valls. It stated:

*"The working group will assess options for the **renegotiation of the existing concession agreements** or in the alternative, the **termination** of these agreements."*

"The Government has decided to defer the toll increases contractually scheduled for February 1."

This new information posed great uncertainty for MQA and as a result the share price fell ~7% from $3.11 to $2.90.



After this announcement and the resultant negative share price impact, we quickly confirmed that MQA hold contractual rights in respect to its concession agreements with the French State. In MQA's opinion, any breach of the toll road concession by the French government would be successfully defended in court.

Further evidence of MQA's position occurred on February 5th. According to sources in the Le Monde newspaper[12], the French Government had granted permission for the **state owned toll roads**, Mont Blanc Tunnel and the Maurienne Motorway, to increases prices. This seemed contradictory and hypocritical given the French government's stance on the **privately owned toll roads.**

At this stage our view was that three near term possibilities existed:

1. Toll increases would be held up in a French High Court

2. The French government would keep tolls flat but compensate toll road owners

3. The status quo would be maintained

As all of these scenarios where fairly **valuation neutral,** we decided to build a position in MQA. Our logic was that the market may have over-reacted to the initial Government announcement and that new information was now available that made MQA's argument stronger to justify their contractual toll increases.

[12] LeMonde, 4th February 2015, Dominique Gallois

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The share price gradually recovered as political risk subsided…

As time transpired, the MQA share price began ascending back to where it was trading before the negative announcement from the French government.

On February 24 it was reported in the French newspaper Les Echos that a French parliamentarian had stated:

"*There has been a growing awareness over the hearings that the judgement on the level of profit might have been a bit hasty*".

This statement suggested to us that the Government might be moving onto the back-foot regarding delays for toll increases for privately owned roads.

Valuation

Like many investors, we struggle with the concept of extrapolating the current level of global government bond yields into perpetuity in our valuations. We have chosen to err on the side of caution and use longer term average bond yields (more normalised).

The majority of the valuation for MQA is the **French toll road, APRR**, making up 90% of the valuation. The major risk for the valuation of this asset is an unanticipated slowdown in the French economy and a lack of inflation. This is critical for two key reasons.

- **Traffic growth** on the toll road is linked to the strength of the French economy
- Tolls are linked to the **level of inflation** multiplied by 0.7 or 0% growth (whichever is highest)

By way of stress-testing, we examined the global financial crisis period to determine the impact on these two drivers.

- At its worst, **French GDP** troughed at -4% on a year on year basis in 2009
- French **inflation** troughed at -0.7%.

During this period APRR's traffic **fell 3.9%**.

We have factored in a number of economic shocks like this into our MQA valuation model, and still derive modest upside. Nonetheless this negative economic scenario would probably still drive the share price lower as long term valuation support would be secondary to the imminent reduction in earnings and dividends. **This is the downside investors face in MQA.**

Whilst we have modest valuation support in MQA, we have sold our position in the security at a profit as the inefficiency we were exploiting - an over-reaction to political risk - has played out.

End