Aurora Investment Trust– June 2016

Share Price: £1.54 **Net Asset Value: £1.48** **Premium: 4.1%**

Data as at 30 June 2016

Top 10 Equities at 30 June 2016	(%)
Tesco	12.6
Barratt Developments	12.0
Lloyds Banking Group	10.7
Bellway	10.5
Sports Direct	9.8
Morrisons	6.3
GlaxoSmithKline	6.2
JD Wetherspoon	5.3
Vesuvius	4.6
Diageo	3.0
Cash Position	14.8

This month's commentary is longer than usual and is adapted from the report sent to Phoenix UK Fund investors at the end of June. Following the EU Referendum result the housebuilders fell 25% on the first day and over 20% on the next. We added to Barratt and Bellway and at the month end our holdings are 12.0% and 10.5%. We had been adding more to our Sports Direct holding before the EU vote; the price was depressed because it was ejected from the Stoxx 600 Index on June 20th. We bought more following the vote. In total during June, we deployed over 10% of the Trust's assets, all from cash, which was 14.8% at the end of the month.

Housebuilding

There is a big disconnect between the accounting profits of a housebuilder and the cash generation when house prices are moving.

For example, let's model a housebuilder that builds and sells one house a year. Initially a house sells for £200,000 but in year 2 prices drop by 10% to £180,000. In Table 1 you can see the effects on profits which drop from £40,000 to £20,000. A halving. This is what the market is trying to discount right now, a modest fall in prices has a disproportionate impact on profits. Irrespective of this, the housebuilder continues to buy land on an on-going basis.

__Table 1__

Year	*1*	*2*	*3*	*4*
House Price	*200*	*180*	*180*	*180*
Build & Sell Cost	*110*	*110*	*110*	*110*
Land Cost	*50*	*50*	*50*	*34*
Profit	***40***	***20***	*20*	*36*

Notice how in Year 4 the accounting profit jumps back up. This is because it takes about 3 years to turn around a piece of land and so by year 4, the land bought after the house price fall is coming through in the accounts. ***Falls in house prices are immediately reflected in current land prices.*** *Here is a simple Land Model (**Table 2**):*

__Table 2__

Year	*1*	*2*
House Prices	*200*	*180*
Build & Sell Cost	*110*	*110*
Desired Profit Margin	*20%*	*20%*
Profit	*40*	*36*
Land Price	***50***	***34***

As you will see the land price falls immediately in year 2 and this has an immediate cash benefit. When viewed through the lens of cash generation the housebuilder looks quite different. See Table 3.

Table 3

Year	1	2	3	4
House Price	200	180	180	180
Build & Sell Cost	110	110	110	110
Land Cost	50	34	34	34
Profit	**40**	**36**	36	36

When house prices drop by 10%, the cash profits of the business drop by 10%, not the 50% in the accounting profits of Table 1, as a result of the housebuilder purchasing replacement land at a lower price. If you grasp this concept then you have a gift that will keep giving.

Of course, it is also really important that housing supply has been and still is undershooting household formation. For this we can thank the incredibly bureaucratic planning system that we have in the UK which we cannot blame on the EU. Local democracy also helps in thwarting housing construction; people want houses, but not near them. This also helps with the high barrier to entry that has kept out any meaningful competition in the past few decades.

Using Tables 1 & 3 you can see how our investment is likely to turn out. If house prices do drop then accounting earnings will decline and share prices will reflect that, in fact they already have. However, as we approach year 3, a jump in accounting earnings will be in the pipeline and at some point that will be reflected in prices. From our perspective, cash is what drives intrinsic value and we don't mind waiting for it to be reflected in share prices.

If house prices don't drop much and that becomes clear in the coming months then even the analysts will be able to see that current prices are wrong.

A key difference from what happened in 2008 is that none of the major housebuilders carry any gearing. Barratt currently has net cash of over £300m compared to debt of £1.7bn at the end of 2007. Without capital structure issues they will be able to carry on, whatever the market conditions may be, delivering houses to an undersupplied market.

As much as everyone frets about governments and economic fluctuations, the main driving force for long terms investors is demographics and innovation. No one understood human motivation better than Abraham Maslow, the psychologist, who co-founded the humanistic movement and died in 1970. He is most well-known for his 1943 Paper 'A Theory of Human Motivation' which introduced the concept of a Hierarchy of Needs driving human behaviour. We have found it a very good predictor of how humans act at an economic level.

The Hierarchy is usually shown as a pyramid and the very base level is physiological needs, i.e. what we need for basic existence. They include food (Tesco, Morrisons), shelter (Barratt, Bellway) and warmth (e.g. clothing, Sports Direct). When you look at these categories of the UK economy you find remarkable resilience. Even during years of recession and the credit crunch the annual consumption of these basic needs never declined.

The majority of the portfolio is in businesses addressing Maslow's physiological needs. We expect turbulence of stock prices and individual business problems but we know we serve a stable market.

The next level of the pyramid is Safety, it is this part that the EU Referendum affects. The uncertainty will cause some to fear for their employment security and this is likely to impact some discretionary spending. So for example the ONS consumption category of Recreation & Culture took 6 years to regain its level of 2008.

It is worth noting that even in a bad recession like 2008-9 the peak to trough fall in employment was 2.5%. In other words 97.5% of the workforce continued to earn and average income has never declined except in 2009 when it fell by £1 a week.

Sports Direct

We have made a substantial investment in Sports Direct because despite all the external noise it remains a first class retailer with a dominant position in its space in the UK and lots of growth opportunities in Europe. In all the years we have been watching them closely they have always beaten Amazon on price whilst making a good margin and a 25% return on its capital. You can't find many retailers like that and certainly not at less than half their intrinsic value.

This quarter Mike Ashley appeared before for a House Of Commons Select Committee. If you want to get a measure of the man's character then we recommend watching it. Not eloquent or erudite but direct and honest. Even the politicians on the committee described him as having been very honest; faint praise! Unfortunately it was light on business and so you don't get to see his real talent. We continue to rate them as outstanding.

Brexit

We have in the past made a number of mistakes and misjudgements from paying too much attention to the words of ministers. In the end we have found that most government action is the work of civil servants. As the UK seeks to negotiate a way out of the EU, we can take a lot of comfort from the fact that the people working on the detail will be competent and sensible. We also take some comfort that the line-up of potential political leaders are likely to pursue a sensible solution and that means avoiding economic suicide.

A study of past EU plebiscite crises shows that after the initial emotive outbursts the machinery of the EU turns itself to finding pragmatic solutions. So whether it's a Norwegian model, a Brexit-lite, an associate member or a new overall European treaty we think that the most probable outcome will be something that works for the UK economically because at a very minimum it will need to be passed through a parliament that, across all parties, is in favour of being in Europe and will be held to account at the next election.

Risk

The way we manage risk at Phoenix is to study and monitor our businesses in action. As you would have expected we have already been out on building sites in London, the Midlands and Yorkshire taking a post referendum snapshot. It is too early to judge the impact, but so far sites are still active and although we are out as cash buyers there is no sign yet of lower prices. The further you get from London the less concerned they *seem to be. In Yorkshire, football seems to have had more impact than politics. From nearly two decades of observing human behaviour at the point of consumption we are struck by how right Maslow was, what drives people is not politics but the habits, desires and aspirations of everyday life.*

Value

Our approach is about getting good value which is a function of what you've bought and how much you've paid for it. We talk a lot about what we own, but the great driver of returns is the value. No one wishes chaos and turmoil on their country, but we did realise that a Leave vote could herald an early Christmas for a value investor with cash. As with Christmas, you never know what you are going to get until you come down in the morning, and for us it turned out to be some of our favourite things. Amongst the sectors most hit were housebuilders, banks and retailers. By deploying our cash at those overreacted prices we have, we believe, added lots of value.

Using our valuation estimates (intrinsic values) for each Investment in the portfolio, we think that the NAV of the Trust now has an upside of 111% (which includes the current cash weighting) To put this into context, the upside using the same methodology was 76% at the end of March 2016, indicating (along with a decline in the NAV) that substantial value has been added in the last three months. This is not a forecast of future investment returns, although over the 18 years that Phoenix has been in business, the best guide to our long term performance has been the upside to intrinsic value, with upside above 100% demonstrating a consistently positive correlation with strong long term investment performance.

So we believe we have been doing what we do best. Busy adding lots of value whilst damaging the current price level. Our capital is committed in businesses we know well and monitor closely. As we've demonstrated before, whatever the upcoming storm it is the underlying value that ultimately drives returns.

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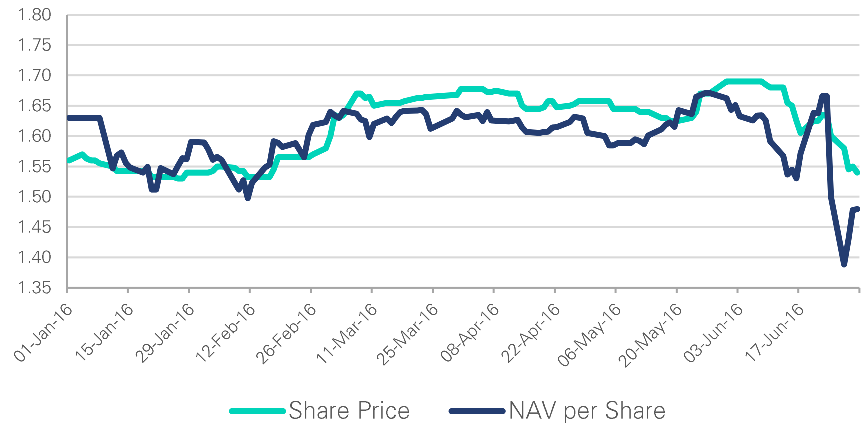
Share Price & NAV per Share (to 30 June 2016)



Trust Performance

The appointment of Phoenix Asset Management Partners ("PAMP") came into effect on 28th January 2016. PAMP's investment track record for its flagship Phoenix UK Fund can be viewed in the table and graph on the page 2. The investment strategy of the Aurora Investment Trust is the same as that of the Phoenix UK Fund.

Track Record

Performance	NAV Return %	Share Price Return %	All-Share Index % *	Relative NAV to ASX %
01/01/16 – 30/06/16	-8.8	-0.7	4.3	-13.0
June 2016	-10.4	-8.3	2.8	-13.3

* All-Share Index Returns with dividends reinvested

During January 2016, the portfolio was changed to align to Phoenix. The IM Agreement between Aurora and Phoenix formally began on 28 January.

Aurora shares are eligible to be invested in an ISA. Neither the Aurora Investment Trust nor PAMP run such a scheme. You should consult a financial adviser regarding a suitable self-select ISA provider.

Investment Objective

We seek to achieve long-term returns by investing in UK-listed equities using a value-based philosophy inspired by the teachings of Warren Buffett, Charlie Munger, Benjamin Graham and Phillip Fisher. Our approach, combined with thorough research, invests in high quality businesses run by honest and competent management purchased at prices that, even with low expectations, will deliver excellent returns.

Contact

Phoenix Asset Management Partners Ltd
64 – 66 Glentham Road London SW13 9JJ
Tel: +44 (0) 208 600 0100

Fund Manager since 28 January 2016

Portfolio Manager:	Gary Channon
Listing:	London Stock Exchange
Inception Date:	13 March 1997
ISIN:	GB0000633262
Bloomberg:	ARR

Fees

Management:	None
Performance:	One third of returns in excess of the market

Regulatory Notice:

Aurora Investment Trust Plc ("the Trust") is a UK investment trust listed on the London Stock Exchange. Past performance is no guarantee of future performance. The value of investments and any income from them may go down as well as up and investors may not get back the amount invested. There can be no assurance that the Company's investment objective will be achieved and investment results may vary substantially over time. This document is for information purposes only and does not constitute an offer or invitation to purchase shares in the Trust. Shares in an investment trust are traded on a stock market and the share price will fluctuate in accordance with supply and demand and may not reflect the underlying net asset value of the shares. This document is issued and approved by Phoenix Asset Management Partners.

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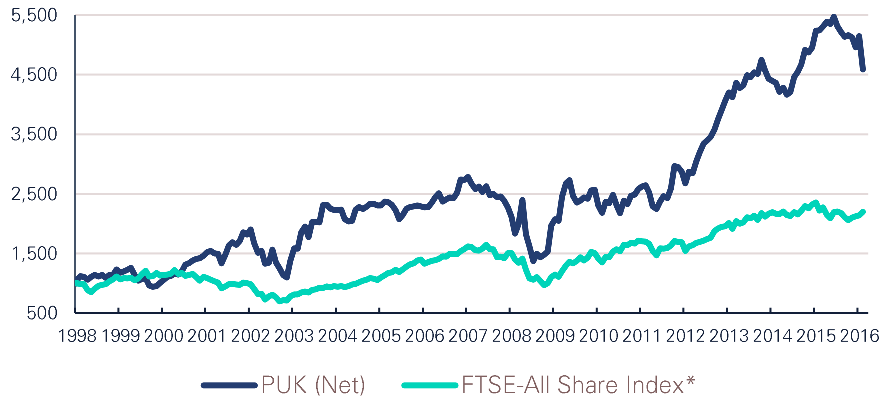
Phoenix UK Fund Track record

Fund Performance (%)	Gross Return	Net Return	All-Share Index*	Relative NAV to ASX
2016 (to 30 June 2016)	-11.4	-11.9	4.3	-16.2
2015	20.1	14.7	0.9	13.8
2014	2.0	0.1	1.2	-1.1
2013	40.5	31.3	20.9	10.4
2012	48.3	42.2	12.5	29.7
2011	3.0	1.9	-3.2	5.1
2010	1.1	0.0	14.7	-14.7
2009	62.8	59.7	30.2	29.5
Cumulative Since Inception	619.5	359.0	128.2	230.8
Since Inception Annualised	11.5	8.7	4.6	4.1

The data on this page reflects the track record of the Phoenix UK Fund. The investment strategy of the Aurora Investment Trust is the same as that of the Phoenix UK Fund.

Phoenix UK Fund Value of £1,000 invested at launch to 30 June 2016



* Data from 30th April 1998, All-Share Index Returns with dividends reinvested

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