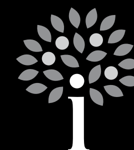
Value Fund
Quarterly Update



JANUARY 2010

Performance review

Welcome to the first Value Fund Quarterly Update. About 400 investors have invested more than $10m in the Fund so far. If you are one of them, thank you. We've been extremely pleased with the level of interest in the fund and the enthusiasm for it. Now the real work begins.

Each quarter, we'll be producing a report much like this one; featuring three sections covering performance, portfolio commentary and a few general observations.

As we only hung out our shingle in November, the performance thus far is no guide as to our competence or otherwise (I promise I would have said the same thing were the returns the other way around). For the record, the unit price is up 1.8% since inception while the All Ordinaries Accumulation Index was up 5.7% in the same period.

SUMMARY OF RETURNS	
1 month return	2.57%
Return since inception (2 November 2009)	1.81%
Number of stocks in portfolio	10

Portfolio commentary

So far, we've invested approximately 50% of the $10m cash contributed to the fund during the first two months. The investments mostly consist of large, liquid infrastructure funds. Together, **Prime Infrastructure** (our largest holding), »

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» **MAp Group** (the old Macquarie Airports), **Australian Infrastructure Fund**, **Spark Infrastructure** and **SP Ausnet** represent 32% of the fund and 66% of the invested portfolio. With the exception of Prime Infrastructure securities, which ended the quarter in line with our average acquisition price (adjusted for a distribution before the recapitalisation), all are showing unrealised gains. MAp, in particular, ended the December quarter up 14%—despite paying an 8-cent distribution—and Spark Infrastructure closed up 12% on our purchase price.

We expect good, but not spectacular, long-term returns from most of these stocks. Spectacular short-term returns, should they make an appearance, will be attributable to luck.

You should, however, sleep well at night knowing that every time someone shuffles through a major Australian airport, uses electricity in Victoria or South Australia, exports coal from Queensland's Bowen Basin or harvests a wheat crop in Western Australia, a tiny slice of the revenue generated comes back to you.

RHG added to the portfolio

RHG Group was sold off heavily in December after announcing it had lost a court case and would suffer financial losses. Having conducted extensive research on the company over a long period, we felt comfortable with acting swiftly to take advantage of what we perceived was an over-reaction in the stock price and added RHG to the portfolio.

A subsequent announcement indicates that the final financial impact will not be as substantial as many, including us, feared. Thus far, this has not been reflected in the stock price, which continues to languish around 8% below our average purchase price.

With hindsight we could have purchased stock more slowly and achieved a slightly lower average entry price, but we're nonetheless glad to have established a modest position in this company at a price that we believe will prove to be very attractive.

In addition to the stocks mentioned above, we have taken small positions in another five companies. These are all small to mid-sized companies in diverse industries. We're very keen to own more of these stocks at the right price or—in the case of the smallest—as we are able to find stock to purchase. That's why we believe it is in unitholders' best interests that we do not disclose these positions at this time.

General commentary

Paying the price for shareholder rescues

Many Australian investors feel that the capital raising frenzy of the past 12 months was a gift from God. 'Free money' I heard it described as and, in some cases, it was. Small shareholders that were offered $15,000 share purchase plans at substantially discounted prices were sometimes able to make more than their initial investment simply by participating.

But shareholders as a whole cannot 'win' out of a capital raising without the capital being put to good use and having it earn above average returns. Most of the capital raised over the past year has been expensive equity used to repay what was once very cheap debt.

The net result for investors is a loss, not a win, and this will become obvious to all shareholders over the next year. The cost will manifest itself in substantially lower earnings per share.

Selection of holdings

STOCK	BUSINESS	PORTFOLIO WEIGHTING
AS AT 31 DECEMBER 2009		
Prime Infrastructure Holdings	A diversified infrastructure fund. The main investments are Northern Gas Pipeline in the US, Queensland's Dalrymple Bay Coal Terminal and WestNet Rail—a rail network in Western Australia.	13%
SP Ausnet	Owns the electricity transmission assets in Victoria. These assets transfer electricity from producers, such as coal stations, to distribution networks, such as those owned by Spark Infrastructure.	5%
RHG Group	An asset play with an estimated 83 cents of net tangible assets, plus the rights to income from a $5bn mortgage book.	5%
Spark Infrastructure	Has an effective 49% interest in the electricity distribution networks in Melbourne's CBD, Western Victoria and South Australia.	5%
Macquarie Airports	Owns a majority stake in Sydney Airport and several other smaller airport investments including stakes in Brussels and Copenhagen Airports.	5%

Ignoring growth, franking and other complicating factors, when a stock is priced at 8 times pre-tax earnings, investors are demanding a return of 12.5% (1 divided by 8). If you raise equity at a cost of 12.5% per annum and use it to repay debt that was costing 5% per annum, there is going to be a lot less cash left over on a per share basis.

You won't read about that in the press releases. Most PR savvy companies will probably follow Wesfarmers lead and focus their attention on growth in 'net earnings' while failing to mention a decline in the more important earnings per share. But for those prepared to do a little digging, the cost of last year's rush for capital is about to become painfully apparent as reporting season rolls around. You can read more about the impact of capital raisings on earnings per share in my recent Bristlemouth blog post.

Positioned for safety

We're not going to generate sensational returns with half the portfolio in cash. Our goal is to be mostly invested, most of the time. While we've made a good start, we're treading very carefully. That's partly because most prices look reasonably full. But it's also because we remain extremely concerned about the global backdrop.

The problem the world economy faces is that none of the underlying imbalances that caused the most recent crisis have been corrected. In a recent article in the *Financial Times*, John Kay summarised my thoughts much better than I could:

> *Governments, and particularly the US government, reacted on each occasion by pumping money into the financial system in the hope of staving off wider collapse, with some degree of success.*

»

» *At the end of each phase, regulators and financial institutions declared that lessons had been learnt. While measures were implemented which, if they had been introduced five years earlier, might have prevented the most recent crisis from taking the particular form it did, these responses addressed the particular problem that had just occurred, rather than the underlying generic problems of skewed incentives and dysfunctional institutional structures …*

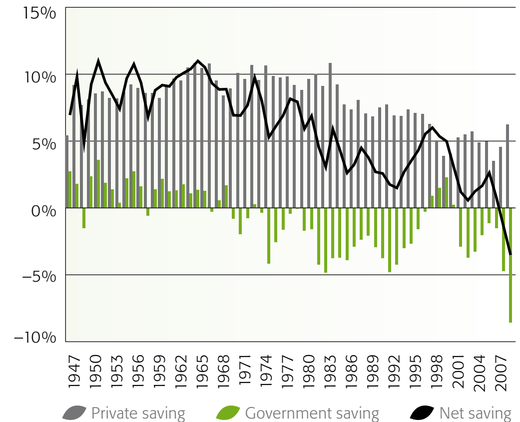
The recent crisis taxed to the full—the word tax is used deliberately—the resources of world governments and their citizens. Even if there is will to respond to the next crisis, the capacity to do so may not be there.

The cycle of larger and larger bailouts has the whiff of a ponzi scheme about it. At some point, the citizens of western economies are going to have to adjust to a lower standard of living. We have no idea when that adjustment will take place, how severe it will be or what the impact on Australia will be, but we're preparing the portfolio for a difficult environment.

Our approach is threefold:

1. Purchase stocks that are relatively immune to the economic cycle (hence the large allocation to infrastructure stocks);
2. Purchase stocks where the growth is such that the overall level of economic activity is only a small factor relative to the company's market growth or growth in market share; or

SAVINGS RATES IN THE US (% OF GDP)



Source: US Bureau of Economic Analysis.

3. Purchase stocks that are so cheap that we can afford a serious recession and still do well.

We're finding enough potential opportunities in all three areas to keep us very busy and we hope that remains the case through 2010.

Yours sincerely,

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