Funds Management Quarterly Report

June 2013

INTELLIGENT INVESTOR INTERNATIONAL FUND | INTELLIGENT INVESTOR VALUE FUND

Intelligent Investor Funds
PO Box Q744
Queen Vic. Bldg NSW 1230
T 02 8305 6050
F 02 8305 6042
admin@iifunds.com.au
www.iifunds.com.au

INTELLIGENT INVESTOR

RESPONSIBLE ENTITY
Fundhost Limited
+61 2 8223 5400
admin@fundhost.com.au
www.fundhost.com.au

INVESTMENT MANAGER
Intelligent Investor Funds Pty Limited
+61 2 8305 6050
admin@iifunds.com.au
www.iifunds.com.au

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Nothing new about troubled times

In the introduction to the 2005 Vintage edition of *Midnight's Children*, author Salman Rushdie puts the year in which he started the book, 1975, into context:

'India became a nuclear power and Margaret Thatcher was elected leader of the Conservative Party and Sheikh Mujib, the founder of Bangladesh, was murdered; when the Baader-Meinhof Gang was on trial in Stuttgart and Bill Clinton married Hillary Rodham and the last Americans were evacuated from Saigon and Generalissimo Franco died. In Cambodia it was the Khmer Rouge's bloody year zero … and Mrs Indira Gandhi was committed of electoral fraud [in India].'

I read those words a few weeks ago, on a plane, returning from Europe and contemplating the economic problems that continent faces. Yes, it is a seemingly intractable set of problems. Yes, there is going to be upheaval and turmoil as these problems are resolved. But, unique as today's problems are, there's absolutely nothing unusual about the world confronting extraordinary situations. Whether it's 1975, 1981 or 2013, there is something going wrong somewhere.

Our job is to build portfolios that can withstand many different scenarios, accept that the world is going to change and look to profit from turmoil when it arises.

On that front, much has come to fruition over the past 12 months. The Value Fund returned investors 36.9% for the financial year to 30 June 2013 and has now returned 11.3% p.a. since inception, versus 5.1% for the All Ordinaries Index (with dividends included). The International Fund unit price has risen 14.7% since its launch in February.

"Unique as today's problems are, there's absolutely nothing unusual about the world confronting extraordinary situations ... Our job is to build portfolios that can withstand many different scenarios, accept that the world is going to change and look to profit from turmoil when it arises.

TABLE 1: PERFORMANCE TO 30 JUNE 2013

	1 QUARTER	1 YEAR	3 YEAR	SINCE INCEPTION
VALUE FUND	3.38%	36.87%	15.74% pa	11.33% pa
ASX ALL ORDS ACCUM. INDEX	–3.33%	20.67%	7.96% pa	5.11% pa
INTERNATIONAL FUND	15.75%	–	–	14.73%
MSCI ACWI IMI	13.36%	–	–	14.22%

In addition to some outstanding individual stock returns, both portfolios have been constructed to provide protection against a significant slowdown in the Chinese economy, and to benefit from a recovery in the US and the potential appreciation of the US dollar. While these two themes are popular now, and are reflected in the prices of some of the stocks we own, they weren't 12 months ago (which is why we were able to buy US exposure incredibly cheaply).

It is worth reflecting on what has happened.

Ben Bernanke and his colleagues at the Federal Reserve have, using monetary alchemy previously contemplated only in the academic dissertations of Bernanke's Princeton alumni, managed to nurse the US economy through an otherwise devastating period of debt reduction. Unemployment, whilst high and certainly higher than the official figures, remained well below the levels of the Great Depression—something that was a serious possibility with the US financial system on the verge of collapse in late 2008.

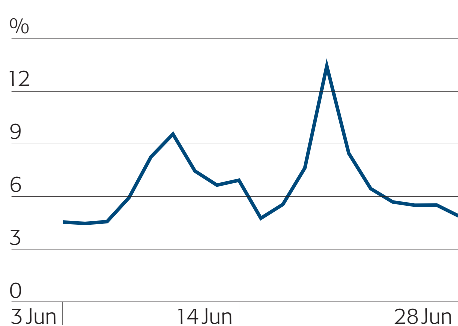
Defying the doomsayers, inflation has remained in check and the US dollar has recently strengthened, not collapsed as predicted. The overall economy is growing, if only modestly, and unemployment is ticking down slowly. The Fed has even suggested it may start unwinding its ultra loose monetary policy as early as the end of this year.

Bernanke's vociferous critics—Bill Gross, Nassim Taleb and Jim Grant, just to name a few—might know a thing or two about financial markets. But the evidence is in that Bernanke and his colleagues know a lot more about monetary policy, what really causes inflation and how to stop a great depression.

The job is only half done. Now that a meltdown has seemingly been averted, the boffins are turning their minds to extracting themselves. Like a heroin addict in a methadone clinic,

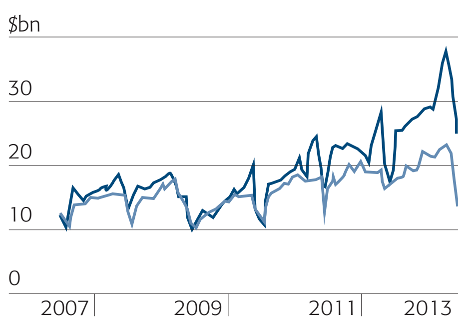
With the currency only allowed to trade within a tightly managed range, it's as close to free money as can be had.

CHART 1: SHANGHAI INTERBANK OFFERED RATE, JUNE 2013



Source: www.shibor.org

CHART 2: THE CARRY TRADE



China's reported exports to Hong Kong
Hong Kong's reported imports from China
Source: Intelligent Investor Funds

the US economy has been saved from death but now needs to show us it can survive and prosper in the real world. Can interest rates return to normal and the Fed reduce its balance sheet without a relapse?

As June's financial market tremors showed, it is not going to be an easy task, and it will be done without Bernanke (he is expected not to run again when his term ends in January 2014).

But we remain more comfortable with our money invested in the US than anywhere else in the world.

Up SHIBOR creek

The other big theme which has influenced the returns of both funds is the Chinese economy. Whereas the portfolios have benefited from direct exposure to the US economy, the China benefit has come from a very intentional minimisation of exposure.

The Chinese economic experiment is showing serious signs of strain and, over the past six months in particular, it is starting to show up in share prices.

For most of the past year the interbank funding rate in China (the rate at which banks lend overnight funds to each other, known as SHIBOR) hovered between 2% and 3%. The rate started to rise in the lead up to the five-day Dragon Boat holiday—something quite normal as people withdraw cash for the weekend—but kept on rising after, when rates were supposed to return to normal. The overnight rate hit a high of 13.9% on Thursday 20 June, amid widespread reports of some smaller banks struggling to get any funding at all and others paying 25% and 30% to secure cash.

As with many events in China, understanding what has happened and why is not easy. But it seems there are two current events driving the current funding crisis and one giant theme behind it all. On the specifics, the Chinese government cracked down on the issuance of Wealth Management Products (WMPs). These investments were pitched to Chinese investors as the equivalent of deposits, while escaping government regulations on the rate of interest that can be paid to depositors (the WMPs typically yield 1% to 2% higher than bank deposits). They had become a significant source of liquidity for the banking system.

So the government edict (nor surprisingly, the authorities don't like anything that circumvents the highly regulated and controlled official system) has had a severe impact on the capacity of banks to fund themselves, although it is unclear why the cash from maturing WMPs isn't turning up as deposits.

The second factor is a dramatic slowdown in the practice of Chinese over-invoicing. In the three months through April this year, China reported exports to Hong Kong of US$112.9bn. Hong Kong customs reported imports from China of US$54.9bn. In theory these two numbers should match. While they never do, the difference should be small and should wash out over time. The gap had never been this large and for years it has been one-sided—China has consistently been reporting more exports to Hong Kong than Hong Kong reports in imports (see Chart 2).

The culprit has been one of the world's simplest money making schemes. Chinese companies have been 'selling' copper and electronic goods to Hong Kong subsidiaries. The Hong Kong subsidiary borrows US dollars to 'buy' copper, for example. The copper never leaves China but the 'export' revenue can be converted into Chinese Yuan and placed on deposit with a Chinese bank. The Chinese company receives the official 3% interest rate, the Hong Kong subsidiary pays US interest rates of less than 1% on the loan, and the 'exporter' collects the differential as profit. With the currency only allowed to trade within a tightly managed range, it's as close to free money as can be had.

Free until the government cracks down on it. Or US interest rates go up. Both of which have happened.

The carry trade has gone into reverse, adding significantly to the Chinese banks' funding woes.

This mini financial crisis is unlikely to spiral out of control. The authorities have plenty of ammunition with which to avert a collapse of the banking system. As we go to press with this quarterly report, interbank rates remain elevated but have fallen significantly, suggesting pressures have eased and that, potentially, the government has been providing liquidity. It does, however, add to the evidence of an end to China's debt fuelled, infrastructure-led, GDP growth.

As we have been saying for the past few years, the government should reform the system—liberalise interest rates and let the exchange rate flow freely being the two most essential reforms—and let the economy restructure.

There has been encouraging evidence of a willingness to head down this path despite the inevitable growth slow down. According to Bloomberg, Chinese Premier Li Keqiang 'signaled determination to stamp out speculation funded by cheap money with a June 19 State Council statement saying banks must make better use of existing credit and step up efforts to contain financial risks.' It is rhetoric, sure, but coupled with an apparent willingness to let the funding crisis unfold, there seems to be serious intent.

If they don't, the economy will collapse. In the banks' funding woes and the lack of GDP growth despite rampant debt creation, there is evidence that the wasteful, debt-funded infrastructure spending is threatening the financial system. We hope the authorities have the courage and political ability to engineer a restructure in time, but fear China is headed for something more dramatic.

The impact on Australia

Either way, it is bad news for Australia. And that has been reflected in the share prices of mining and mining services businesses during the past six months (the ASX 300 Resources Index is down 17.4% since 31 December 2012 and the ASX Small Resources Index is down 48.9% in the same period).

In fact, we have even added a few mining and mining services businesses to the Value Fund during the past few weeks. The China slowdown has only just begun, but investor capitulation is well under way. Some stocks are trading at significant discounts to net cash and at those prices, even we get interested (see page 12).

What's surprising (to me at least) is that no one seems concerned about the wider implications for the Australian economy.

A recent Chanticleer column in the *Australian Financial Review* posited that the mining meltdown was not a concern for the banks because 'the mining boom was largely financed using internal funds rather than bank debt.' In fact, 'The transition from the boom to other sectors of the economy is likely to see greater use of debt and a return to more robust business credit growth.'

"*There is plenty of drama to come in the world. But we remain excited about the investing opportunities ahead of us and navigating whatever challenges come our way.*

Perhaps these mining services businesses are only worth the cash on their balance sheet. Perhaps they will never win another profitable piece of work. But what does that mean for the Australian economy? It's hard to imagine that a sector which has contributed almost all of the Australia's GDP growth for the past five years can fall flat on its face without wider implications for the rest of the economy. Yet the banks remain very near to their all time highs and, in some cases, trade at more than three times book value.

In both the Value Fund and the International Fund, a significant portion of the assets remain invested in US assets or US businesses. Whilst there has been some capitulation in the mining sector and we have dipped a toe in the water, our basic portfolio structures will remain the same until we see much more widespread capitulation or have a clearer understanding on the consequences of China's troubles on the Australian economy.

Attractive opportunities

By the time *Midnight's Children* won the Man Booker prize in 1981, 'Margaret Thatcher was Prime Minister, the American hostages in Iran were released, President Reagan was shot and wounded, there were race riots across Britain, the Pope was shot and wounded … and President Sadat of Egypt was assassinated'.

There is plenty of drama to come in the world. But we remain excited about the investing opportunities ahead of us and navigating whatever challenges come our way. We have been able to add a couple of high quality (and cheap) European stocks to the International Fund as meaningful positions (see page 8). The Value Fund remains significantly invested in US and UK focused stocks. Those stocks are cheap in their own right. And we are cashed up to take advantage of opportunities that come our way.

We want your money

Our little funds management business is at its own inflection point. We'll be four years old in November and now have an excellent track record with our flagship Value Fund. The plan is to grow the Value Fund over the next few years to $150m to $200m, a level

“It’s a world obsessed with stock price volatility, correlations, Sharpe ratios and historical returns. It’s a world that we know is going to assess us on a monthly basis and pull money at the first sign of underperformance. Keep this quiet, but we prefer your money.

at which we think there is a sensible trade-off between business economics for us and prospective returns for you. At the very least, we aim to build a similar track record over the next three years in the International Fund.

We have met with a number of ratings agencies—gatekeepers to the financial planning world such as Lonsec and Zenith—over the past few months. We have also met with a number of overseers of approved product lists for financial planning groups. It’s a world obsessed with stock price volatility, correlations, Sharpe ratios and historical returns. It’s a world that we know is going to assess us on a monthly basis and pull money at the first sign of underperformance. Keep this quiet, but we prefer your money.

At the moment, we have investors who understand our long-term approach, understand that our returns will be volatile and understand that we do make mistakes. This is probably the main advantage we have over our value-investing competitors.

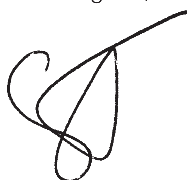
We would like to keep that advantage, which means more of your money and less return chasers. If we can grow the Value Fund to the $150m to $200m we want with patient, long term money, we can enjoy spending the next 20 years investing it sensibly on your behalf, without any outside distractions.

Coming straight to the point, I’d like you to consider your investment in the Value Fund. Hopefully you know my views on this Fund in a portfolio context—it should form a smallish part of a well diversified portfolio—but if you have the capacity to add more to your investment and are happy with the job we are doing, please consider it over the coming months. I’d like to see how much we can raise from within the family before heading outside.

The International Fund is a different prospect. While we are unproven in this space, our size is a tremendous advantage at the moment. You won’t find B&C Speakers (see page 8)—with a €42m market capitalisation—in the Platinum or Magellan portfolios. And in case you didn’t get the message in the previous pages, despite the gains made already, we still think currency diversification is essential for the average Australian investor.

I say this with a tinge of self-interest but a lot of concern. If you want to increase your allocation to international shares and think our fund is a sensible option for you, while the International Fund is small and the dollar is high, it makes sense to get on with it.

Kind regards,



Steve Johnson
Chief Investment Officer
Intelligent Investor Funds Management

International Fund

The weak Australian dollar has given the International Fund a flying start. The unit price rose 15.7% in the three months to 30 June 2013, 2.4% more than the MSCI Index[1]. While the returns are mostly a result of the weak currency, the underlying portfolio has also been performing well, and significant progress has been made on the investment front. The total percentage invested is approaching 50% thanks to the addition of a few attractive small capitalisation stocks.

Airports on our radar

In May, Kevin, Steve and Gareth spent a week together in the Vienna office, working hard to find more European bargains for the International Fund (yes, you should feel sorry for us, it was cold and raining the whole time). Time was dedicated to European airports, as some look quite cheap. Gareth has continued researching the sector during June.

There are many important differences between individual airports—pricing regulation, age and maximum capacity of existing terminals and runways, ownership of assets (freehold or leasehold), baggage handling (in-house or external), exposure to national carriers, long term growth in passengers, the split between transfer and destination/origin passengers (the latter are generally more valuable) and whether the airport is run for genuine profit or prone to political influences, to name but a handful.

Despite their shortfalls, a few simple metrics do highlight a lot. The enterprise value to earnings before interest, tax, depreciation and amortisation (EV/EBITDA) ratio quickly highlights how much the market is prepared to pay for an airport's current earnings stream. The enterprise value per passenger (EV/pax) ratio is a little more nuanced, highlighting value against total earnings power (both tapped and untapped).

As Table 4 highlights, some European airports look cheap next to standalone Antipodean equivalents.

TABLE 4: AIRPORT COMPARISON

	VIENNA	ZURICH	COPENHAGEN	FRANKFURT	PARIS	SYDNEY*	AUCKLAND
EQUITY (M LOCAL)	922	2,912	18,835	4,282	7,391	7,401	3,928
DEBT (M LOCAL)	750	1,230	3,165	3,905	3,090	6,303	1,108
ENTERPRISE VALUE (M LOCAL)	1,672	4,141	22,000	8,187	10,481	13,704	5,036
ENTERPRISE VALUE (M €)	1,672	3,367	2,949	8,187	10,481	9,593	2,971
PASSENGERS (TOTAL M)	22.2	24.8	23.3	99.4	88.8	36.9	14.0
AVERAGE ANNUAL PAX GROWTH (10 YEARS, MAIN AIRPORT)	6.8%	3.30%	3.2%	1.7%	0.6%	4.4%	4.8%
EV/NORMALISED EBITDA (TIMES)	**7.6**	**8.9**	**11.0**	**9.6**	**10.3**	**16.2**	**15.8**
EV/PASSENGER (€)	**75.3**	**135.8**	**126.6**	**82.4**	**118.0**	**260.0**	**212.2**

* On a 100% ownership basis.

But don't mistake the lowest price tag for the best investment opportunity. Some airports come with warts and might deserve their steep discount. We've already ruled out investing in the apparently cheapest airport, at least at current prices.

Vienna Airport

Steve and Gareth met with senior management a few weeks back, and there's a lot to like about the airport. Solid passenger growth over the past decade seems likely to continue this decade. Terminal 3 opened last year and that means that no major terminal additions will be required for at least a decade. And the stock looks superficially cheap.

[1] The International Fund's benchmark is the MSCI ACWI IMI, comprising developing and developed markets.

TABLE 1: SUMMARY OF RETURNS AT 30 JUN 2013

	INTELLIGENT INVESTOR INTL FUND	MSCI ACWI IMI
1 MONTH	3.47%	1.68%
3 MONTH	15.75%	13.36%
SINCE INCEPTION*	14.73%	14.22%
PORTFOLIO VALUE	**$21.2m**	

*8 February 2013

TABLE 2: UNIT PRICE SUMMARY

DATE AS AT	30 Jun 2013
BUY PRICE	$1.1519
REDEMPTION PRICE	$1.1427
MID PRICE	$1.1473

TABLE 3: FUND FACTS

FUND COMMENCED	8 Feb 2013
MINIMUM INVESTMENT	$20,000
MINIMUM MONTHLY INVESTMENT	$200
INCOME DISTRIBUTION	Annual, 30 June
APPLICATIONS/REDEMPTION	Weekly

> *European airports look cheap next to standalone Antipodean equivalents.*

TABLE 5: FUND CURRENCY EXPOSURE

CURRENCY	EXPOSURE (% OF PORTFOLIO)
USD	58.0%
EUR	19.1%
GBP	7.9%
JPY	4.4%
CAD	3.4%

But it failed to clear our hurdles. The T3 expansion was botched, with significant cost blowouts and, more importantly, it's yet to prove it can generate decent incremental returns from the large investment. The airport has tripled its capital base over the past decade, which can be seen in the shiny new Terminal 3, in the large new business park offering office space adjacent to the airport and in new parking facilities. These assets are being used by a greater number of passengers than ever. But the company has been unable to eke out significant extra profit despite the large investments. Expressed another way, ROCE has fallen from 20%+ to roughly 7% over the past decade. It was malinvestment on a fairly massive scale, of the sort that often involves government meddling (part of the explanation here).

Management has changed, holding out the promise that the future might be sufficiently different to the immediate past. But we're not adequately certain. We pressed management on their hurdle rates for future growth capital expenditure, and they responded with the answer '8% pre-tax'. We had to ask again. This is an extraordinarily humble hurdle for a capital-constrained business (for various reasons, we believe the airport is unlikely to issue new shares or take on significant borrowings in the near future). We have suspicions that the low hurdle will, by accident or design, allow the company to use the capital it can access (mainly through retained earnings) to pursue the more politically-motivated growth projects (a 3rd runway, for example) rather than take advantage of the abundance of low hanging fruit that might generate 12–15% returns, such as revamping the underwhelming retail operations at the airport.

"For political reasons, Kerrie is unlikely to be taking German lessons any time soon.

Management does have a plan to refresh the dated Terminal 2, and possibly centralise security for the entire airport in the process. But with such low return hurdles on the large amounts of profits being retained and reinvested in the business, we're not convinced that Vienna Airport is currently the right place for your money. If someone like Kerrie Mather (of Sydney Airport) was to take charge that could change overnight but, for political reasons, Kerrie is unlikely to be taking German lessons any time soon. We're keeping an eye out for a lower share price or a change in attitude regarding the sanctity of retained capital. In the meantime, it's cheap but potentially deservedly so.

Zurich Airport

Higher up our list is the **Zurich Airport**. We're yet to visit the airport or pull the buy trigger but have had a long conversation with management and like most of what we hear. Whereas Vienna offers potential aplenty, Zurich is already a proven performer. Though only slightly bigger than Vienna in terms of average passenger numbers, Zurich generated more than twice as much non-aeronautical revenues and nearly twice as much overall underlying EBITDA.

Those numbers are helped significantly by Switzerland's unique position in the heart of Europe but outside the EU—meaning most departing passengers qualify for duty free shopping. The airport already has three runways and spanking new facilities that should suffice for many years of growth, though there is one terminal that still needs an upgrade.

There are also further growth capital expenditure options that will require capital but should add to the bottom line in the process. Compared with Vienna, we're more confident that future passenger growth will flow through to shareholder returns, and the stock looks quite cheap.

Other European airport options include Frankfurt, Paris and Turkish operator TAV Airports, but for now Zurich looks the most attractive option.

From Vienna the team headed south and west and visited a dozen prospective companies in UK and mainland Europe in May and June. Here's one that the fund has already taken a position in.

TABLE 6: SUMMARY OF HOLDINGS

STOCK	COUNTRY	PORTFOLIO WEIGHTING
GOOGLE INC CLASS A SHARES	US	6.9%
AMERICAN INT'L GROUP	US	5.8%
JAPANESE PORTFOLIO OF NET-NETS	Japan	5.4%
B&C SPEAKERS	Italy	5.3%
AMERICAN EXPRESS CO	US	4.5%

B&C Speakers

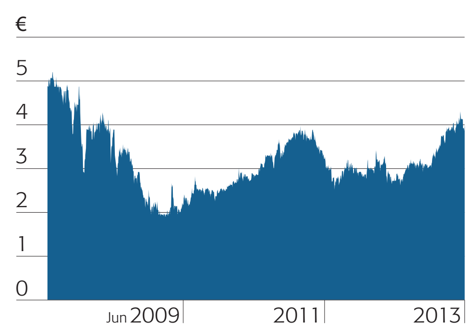
This family-controlled company can surely be considered 'off the radar'. Located in a pretty valley 10kms from Florence, **B&C Speakers** is tiny with a market capitalisation of just €42m, and more than half of that stock resides in the hands of a controlling family. The company currently reports in Italian only (fortunately, one of our junior analysts, Alvise, is a native speaker and we're getting pretty savvy with Google translate too). When we met management and toured the facilities we were the first non-Italian money managers to ever visit head office.

Despite it's small size, B&C Speakers is something of a giant in its field. It makes components for speakers sold to the professional audio market (think outdoor concerts, live music venues, nightclubs and public address systems). B&C doesn't make the whole box but focuses mainly on the noise-making parts—such as high-frequency (HF) and low-frequency (LF) drivers—that high-end speaker makers put into their systems. The pro audio industry gorilla is American company JBL Speakers, which controls perhaps half the global market and does everything in-house. But the rest of the industry, including important innovators like d&b audiotechnik and L-ACOUSTICS, have their drivers made by third parties. For those outsourced components for the pro audio market, B&C is a market leader with about a 25–30% market share globally.

Our thesis is that the company's operating history and reputation for innovation, reliability and outstanding sound give it a moat of some width. Its components make up a small percentage of a professional speaker's overall cost, perhaps 10%, yet are crucial to sound quality and reliability. It's not an area to skimp.

In high frequency drivers in particularly, B&C has only one competitor of note, allowing it to generate handsome margins (EBITDA margin are almost 25% overall, and higher again for HF drivers). Margins were even higher in the past, first squeezed by the financial crisis and then a bubble in the price of neodymium (used for making magnets essential to the component's operation). This rare commodity increased 10-fold in price a few years ago but has now returned to pre-bubble levels. We expect the company's margins to lift, and we also expect decent sales growth in the immediate- and longer-term. The underlying market is steadily growing, and we think B&C's place in the industry is quite secure.

CHART 1: B&C SPEAKERS SHARE PRICE



Source: Capital IQ

You don't see this at home

How much might one expect to pay for a stock selling into a growing market, with large and increasing market share, fat and widening margins, likely future sales growth and sensible owner-manager operators? Well, it's Italian and it's small cap, so let's not get carried away. But a forecast PER of 8 and a 7% historic yield is too cheap. The stock looks at least 30% underpriced, and perhaps significantly more. And we're also not too concerned about the effect of any Italian exodus from the Euro. B&C Speakers is chiefly an exporter and might even benefit from lower wage costs if the Euro dissolved, though the short term could certainly bring turmoil.

> *"How much might one expect to pay for a stock selling into a growing market, with large and increasing market share, fat and widening margins, likely future sales growth and sensible owner-manager operators?*

The fund will be happy holding B&C for many years, to benefit from the likely growth in its market. But there is a chance this investment could play out sooner rather than later. In the next few months, the stock could be admitted to the FTSE Italian STAR Index of fast-growing, small capitalisation companies. A requirement is that it must begin reporting in English, and will do so with the next result. Management is already booked to present at a roadshow in London in October. B&C Speakers might not be 'off the radar' for long.

When the international fund was conceived, B&C was exactly the sort of high quality, underpriced small cap company we envisaged playing a role. We have found another similar quality, similarly priced stock listed on the Oslo Stock Exchange. It's pleasing that those intentions are becoming realities, and the team continues the hunt for more.

But for similar illiquid investments in future, we might not always disclose the stake immediately or even in the medium term. This is so the fund can retain the option to buy more stock cheaply; we don't want ideas poachers shutting down potential opportunities for fund investors. But the fund has already acquired plenty of B&C stock and, on this early occasion, we feel it's important you have a clearer understanding of the type of investment ideas in which your money is being invested.

IDT's undervalued assets

Back in his home country, Kevin Rose found us a new-age business that qualifies as an old-age asset play.

IDT Corporation (NYSE:IDT) is an eclectic collection of very different businesses. The main game is an international long-distance telecommunications business. But it also owns an early stage technology company offering a video storage platform called Fabrix; an online property and mobile app (Zedge) that is consistently ranked amongst the Top 15 free downloaded apps on Android; and a collection of real estate, wireless radio spectrum and intellectural property (IP) patents.

We do not usually come across small cap stocks with such diversity—the universe

tends to be more focused. But IDT is not your typical corporate entity. Instead, it is an investment vehicle for entrepreneur Howard Jonas. Jonas made his fortune in the telecom space having built and sold the company Net2Phone to AT&T for US$1.1bn in 2000. He was also involved with the creation of a number of media companies, including Starz Media which he sold to Liberty Media for US$450m. While his record is not spotless, his winners have largely outweighed his losers, and he has always looked for creative ways to build shareholder value.

When we found IDT, the stock was trading at roughly two times net cash. The long distance business was thought of as low margin, declining and overly competitive (most of its revenue came from international calling cards). The rest of the assets were either underappreciated or ignored entirely. With the share price down 66% from its multi-year high, investors had given up on IDT.

TABLE 6: IDT VALUATION*

	CONSERVATIVE	OPTIMISTIC
IDT TELECOM	$17.75	$27.00
FABRIX	$1.50	$4.86
ZEDGE	$0.40	$2.20
SPECTRUM	$2.50	$10.00
OTHER	$2.50	$4.40
PER SHARE VALUE	**$24.65**	**$48.46**

*Internal Intelligent Investor Funds valuations

But to our surprise, IDT Telecom was not, in fact, a broken calling card business. In 2010, the company launched an online international long distance platform called Boss Revolution. Today, the Boss platform is growing like weeds, and with improving margins, is set to overtake their traditional card business. IDT also has an international mobile top-up service that is growing 30% annually. We estimate that the financials will soon reflect these positive structural changes, putting a big dent in the bear case.

And while we are not in the business of investing in speculative startups, IDT seems to be on to something with Fabrix and Zedge. Despite its youth, Fabrix has already partnered with IBM and signed Cablevision as a major customer. Its revenue is tripling and it is breakeven profit-wise. There is a chance that the company, having the only commercially proven product in its category, could become significant. Zedge also holds promise as other similar mobile properties continue to get bought up at valuations that look absurd to us but make IDT's look puny in comparison.

“The rest of the assets were either underappreciated or ignored entirely. With the share price down 66% from its multi-year high, investors had given up on IDT.

The stock would be interesting if the investment case stopped there. But IDT's collection of radio spectrum and IP patents adds option value which we value investors tend to like. IDT holds 645 licenses for 28 and 38 GHz spectrum covering the entire US, Puerto Rico and US Virgin Islands. We were attracted to the potential for this asset having seen numerous wireless companies snap up spectrum in all shapes and sizes. While this particular band of spectrum has not proved economical in the past (it only operates over short distances), the growing state of our wireless universe is placing increasingly heavier burdens on our infrastructure and changing that equation.

The company sold eight of its licenses last year for US$6.8m to a carrier looking to test its functionality. Extrapolating that trade would imply a value of US$550m or $24 per share for the rest of the portfolio—almost two times our purchase price. While that is most likely a best case scenario, we have no doubt that this spectrum has value. A positive test result from the carrier could quickly lead to increased demand and larger purchases down the line.

The company is not without its warts. Jonas owns 26% of the company but controls IDT through separate Class A voting shares. It's a family fiefdom and the related party transactions concern us. This will only ever be a small investment.

But at the time of our purchase, we were buying the telecom business at a discount and getting the rest of the assets for free. We were optimistic that IDT's owner/founder, Howard Jonas, would find a way to unlock value having already proven to be a shrewd investor in the past. While value investing typically requires a fair amount of patience, it is always nice to see an investment thesis begin to play out sooner than expected. Subsequent to our purchase, the company announced that the spectrum and IP assets would be spun off into a separate listed company.

Investors cheered sending the stock up 34% for the quarter but, while that has taken some of the margin of safety away, we remain enthusiastic about the value on offer.

Value Fund

The Value Fund's unit price increased 3.4% in the three months ended 30 June, 6.7% ahead of the All Ordinaries Accumulation Index which fell 3.3% during the quarter. That leaves the Fund with a 36.9% return for the financial year, compared with 20.7% for the index (both include dividends), and an annualised return of 11.3% since inception in late 2009, more than double the 5.1% return of the index.

The most significant contributors to performance were **Vision Eye Institute**, **GBST** and **QBE** while **Astro Japan** and **UXC** detracted from performance.

GBST gets released from the sin bin

GBST Holdings is a new addition to the Value Fund portfolio over the past few months. The company has two main products, a piece of software called Shares which enables stockbrokers to clear and settle trades, and a product called Composer which enables fund administrators to run their businesses.

The Shares product is boring but profitable, and sits within GBST's Capital Markets Division. Contracts tend to be signed on five-year or longer deals, and customer relationships tend to last twenty years or more. This makes the business quite stable. The costs to establish and maintain the software are relatively fixed, so the advantage belongs to the dominant provider and GBST is the largest in the Australian market, which makes for a healthy bottom line. GBST has earned earnings before interest, tax, depreciation and amortisation (EBITDA) margins of greater than 30% historically.

Earnings in Australia have been lethargic in the last few years due to poor sharemarket conditions and slow trading volumes (40% of its Shares related revenue depends on transaction volumes), however we expect a moderate recovery is likely and the long term prospects for the business are sound.

GBST also has a new product called Syn that sits within the same division and is meant to replace Shares and its equivalents in international markets. It was part of a $40m acquisition that explains why the stock has been in the sin bin. It generated nothing but losses since the acquisition and, whilst they are excited at its potential, we're sceptical. The same core system issues that make Shares hard to take out make Syn difficult to put in.

Whether or not it generates sales, the good news is that the bulk of investment in the product has now been made so it's not likely to be an ongoing drain on profitability.

Composer singing from the hymn sheet

Now we get on to the exciting bit. The Wealth Management division, which comprises the Composer product, is where GBST has been kicking serious goals. The product is used to administer managed funds such as our Value Fund, maintaining investor databases, processing transactions, managing distributions and providing tax summaries.

Composer was developed in Australia but recently it has been making huge gains in the UK market, where reforms to the retail investment regulations are occurring. These reforms, known as the Retail Distribution Review, are designed to improve disclosure and minimise adviser bias caused by commission based remuneration structures (similar to the FOFA reforms in Australia).

TABLE 4: WEALTH DIVISION ON A ROLL

WEALTH ($M)	FY2008	FY2009	FY2010	FY2011	FY2012	FH1 2013
REVENUE	29	23.5	22.8	27.1	36.2	22.6
EBITDA	7	3.7	5.5	6.9	9.2	6.6

As a result of these changes trustees of managed funds are required to upgrade their software systems, and many that previously used their own in-house software are choosing to outsource to Composer. In Table 4 you can see the impact this has had on the wealth management division results (and these numbers are despite a very strong Aussie dollar).

It takes an incredibly long time to generate a sale in this business. Replacing core systems is a huge undertaking—but once they are on board the same factors that made

TABLE 1: SUMMARY OF RETURNS AT 30 JUN 2013

	INTELLIGENT INVESTOR VALUE FUND	S&P ALL ORDS. ACCUM. INDEX
1 MONTH	–0.69%	–2.62%
3 MONTH	3.38%	–3.33%
6 MONTH	19.90%	4.44%
1 YEAR	36.87%	20.67%
2 YEAR (P.A)	21.45%	5.91%
3 YEAR (P.A)	15.74%	7.96%
SINCE INCEPTION* (P.A)	11.33%	5.11%
PORTFOLIO VALUE	**$31.8m**	

*31 Oct 2009

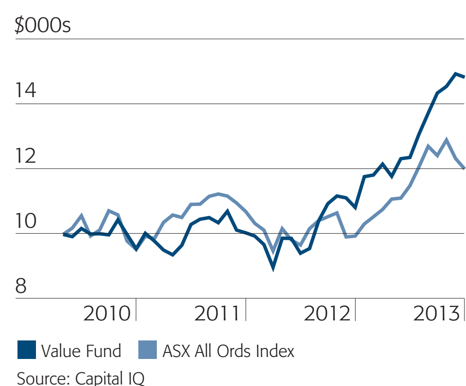
TABLE 2: UNIT PRICE SUMMARY

DATE AS AT	30 Jun 13
BUY PRICE	$1.3385
REDEMPTION PRICE	$1.3278
MID PRICE	$1.3331

TABLE 3: FUND FACTS

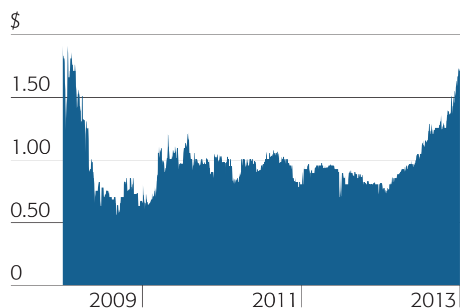
FUND COMMENCED	31 Oct 2009
MINIMUM INVESTMENT	$10,000
MINIMUM MONTHLY INVESTMENT	$100
INCOME DISTRIBUTION	Annual, 30 June
APPLICATIONS/REDEMPTION	Monthly

CHART 1: COMPARISON OF $10,000 INVESTED IN VALUE FUND VS ASX ALL ORDS INDEX



Source: Capital IQ

CHART 2: GBST SHARE PRICE

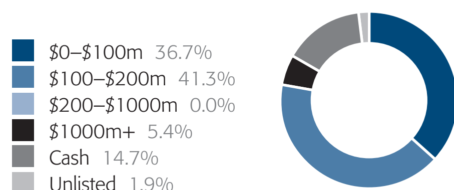


Source: Capital IQ

TABLE 5: GBST VALUATION

AUS CAPITAL MARKETS (EBITDA $M)	9.5
GLOBAL CAPITAL MARKETS (EBITDA $M)	–5.3
WEALTH MANAGEMENT (EBITDA $M)	11
OVERHEADS ($M)	–1.3
EBITDA ($M)	14
NET DEBT ($M)	21
AVG PURCHASE PRICE ($)	1.29
NO. SHARES (M)	67
ENTERPRISE VALUE ($M)	107
EV/EBITDA (X)	7.66

CHART 3: PORTFOLIO DISTRIBUTION ACCORDING TO MARKET CAP



clients difficult to acquire makes them easy to keep. We managed a visit to the GBST office while in London and it seems the UK business is at the point of turning away work due to the quality of its current pipeline, built up over the past five years.

The Fund has been able to establish a decent position in GBST, despite a dearth of liquidity, at an average price of $1.29 per share, which equates to an EBITDA multiple of 7.7 times (see Table 5). We like the price, especially as it already includes their research and development costs which are expensed, not capitalised. If you consider that the global part of Capital Markets won't run at a loss forever, and that we expect higher earnings from Wealth Management and the Australian part of Capital Markets, the multiple looks very modest.

The stock price has risen 31.8% since our acquisition and whilst we still like the business it is obviously not as attractive as it was, even adjusting for the Pound's strength, and we will be waiting for any reversal before acquiring more shares.

Enero's offshore assets

The Fund's investment in **Enero** is not a currency play. We're just hoping for a profit–anything will do. But we did visit three of the company's UK agencies while in London and it's safe to say there is something there. Something that might be worth a lot more if the Australian dollar continues to weaken against the Pound.

Management meetings added some meat to the thesis posited in our last quarterly report; some of the holding company's constituents are losing significant amounts of money and others are doing just fine. At the losing end is Naked, where former News Ltd executive Ian Clark has been shipped in to execute a turnaround. He has his work cut out, although winning the global Virgin Atlantic account will help. In the middle is Frank PR, a successful and nicely profitable business that is still dependent on founders Graham Goodkind and Andrew Bloch. And at the valuable end of the spectrum is Hotwire, a PR company specialising in IT that is successfully spreading its tentacles around the globe on the wings of a global client list. We came home worried about the potential for value to be destroyed if these businesses are not closely supported, but convinced that the value is there for now.

TABLE 6: A SELECTION OF STOCK HOLDINGS

STOCK	DESCRIPTION	WEIGHTING
VISION EYE INSTITUTE (VEI)	Ophthalmology clinics around Australia recovering from historical debt burden.	12.1%
MIRVAC INDUSTRIAL TRUST (MIX)	US industrial property owner in the process of liquidating its assets.	5.9%
GBST (GBT)	Financial Industry software provider in the UK and Australia.	5.4%

Gold, oil and mining services

There are more stocks that usual in the Value Fund at the moment. We've been buying small amounts of a number of mining and mining services business as the investment market for these stocks has capitulated, particularly in the last few weeks of June. Liquidity has been a problem—the second we start buying share prices have often quickly moved against us—and we have no intention of establishing large positions in any of these stocks. But with some trading at significant discounts to net cash or huge discounts to net tangible assets and, in one particular example, less than 1.5 times earnings, we think a basket of them could perform well even if our worst China fears are realised. The number of holdings should remain under 20, but we could end up with quite a few stocks in this space.

Notes

INTELLIGENT
INVESTOR
FUNDS MANAGEMENT

Intelligent Investor Funds
PO Box Q744
Queen Vic. Bldg NSW 1230
T 02 8305 6050
F 02 8305 6042
admin@iifunds.com.au
www.iifunds.com.au