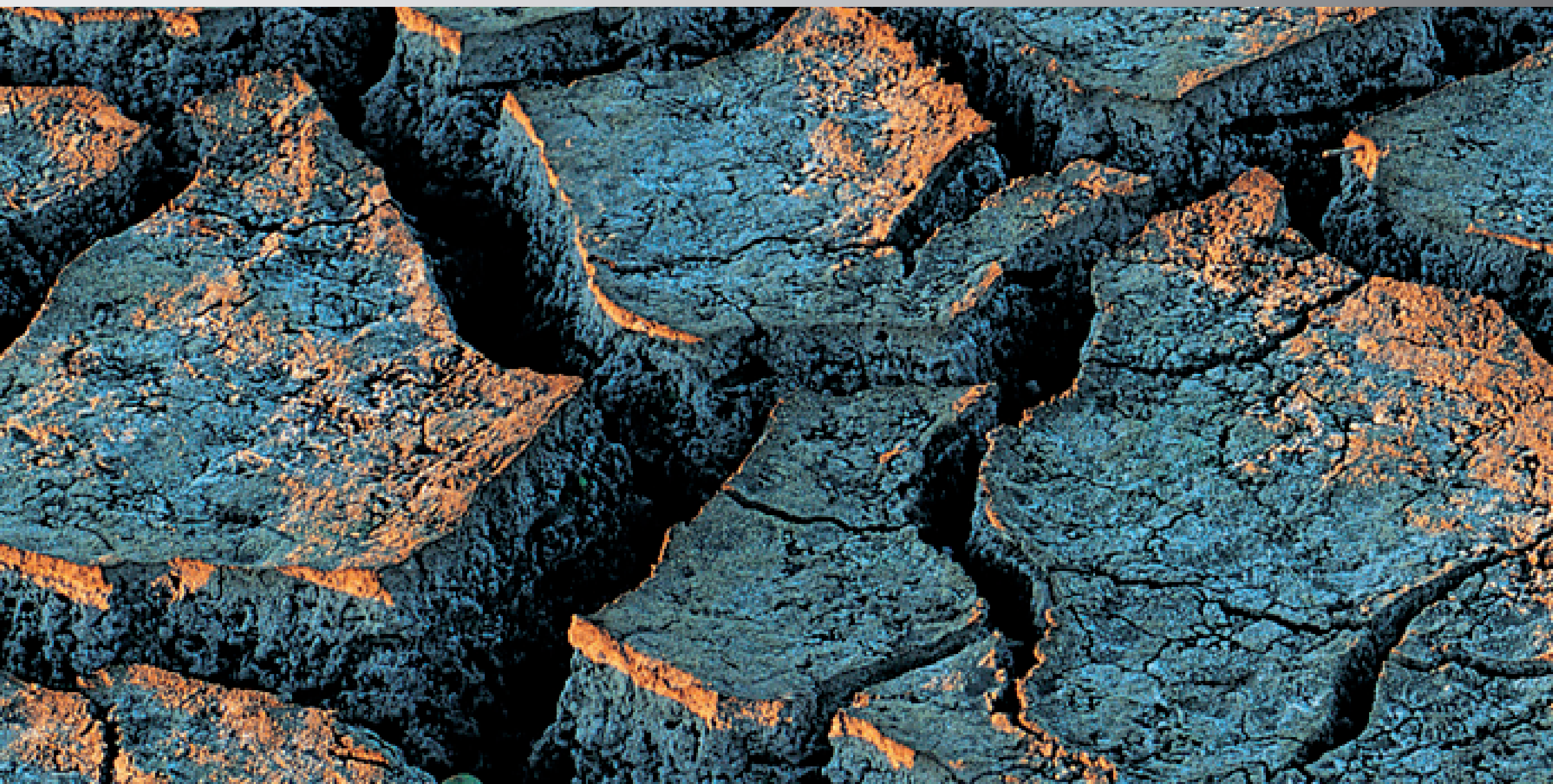
Funds Management Quarterly Report

March 2014

INTELLIGENT INVESTOR FUNDS MANAGEMENT

INTELLIGENT INVESTOR INTERNATIONAL FUND | INTELLIGENT INVESTOR VALUE FUND



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Ducks, decoupling and Desiderata

The first quarter of 2014 was like a duck floating serenely across a pond. Not much happening on the surface, but plenty of activity below it.

Underperformance and outperformance should be eliminated from the long-term investor's lexicon. Don't bother comparing yourself to anyone else at all.

The unit prices of both the International and Value Funds hardly moved over the quarter, yet within the portfolio some stocks, such as **Enero Group** (see page 10) were up as much as 56% while others fell significantly.

PERFORMANCE

	1 QTR (%)	1 YR (%)	3 YRS (% P.A.)	SINCE INCEPTION (% P.A.)
VALUE FUND	0.24	24.65	19.94	14.05
ASX ALL ORDS ACCUM. INDEX	2.20	13.19	7.74	8.01
INTERNATIONAL FUND	–1.45	35.23	–	29.22
MSCI ACWI IMI	–2.19	31.72	–	28.20

What's true of our portfolios is true of stock markets globally. Some businesses (think internet, internet or internet) are flavour of the month and priced for perfection. Others are quite beaten up and represent opportunities. That's good news. We are finding plenty of potential opportunities to keep us busy and, despite still holding plenty of cash, have been able to put some money to work in attractive places over the past three months.

PREPARE TO WATCH WHILE OTHERS GET GREEDY

"If you compare yourself with others, you may become vain and bitter; for always there will be greater and lesser persons than yourself."

There was a time when I could recite Max Ehrmann's Desiderata by heart. Perhaps I simply spent too much time on the toilet. Whatever the reason, the poem pinned to the door of my grandparents' verandah toilet had a large impression on me as a teenager.

The line above is the one that has stayed with me for decades. Sure, it's slightly contrary to the advice The Script gave to the youth of today in their hit song Hall of Fame (You can be the greatest/You can be the best/You can be the King Kong banging on your chest). But that's the appeal.

It's been useful in life and particularly useful when it comes to my job. There is always someone with a better return, a better stock, a better track record and more clients. But comparing yourself to them not only leads to unhappiness, it potentially leads to financial mistakes.

I write this because I've had my close friend and business partner, Greg Hoffman, in my ear the past few months telling me I need to prepare you and the rest of our investors for underperformance. He has added some meat to his argument in his latest article for *Money* magazine.

"After a couple of recent strong years in the sharemarket, you can almost smell what economist John Maynard Keynes described as "animal spirits" in the air. In other words, investors are increasing their appetite for risk ... in buoyant times like these, I prepare to underperform. "Underperform" doesn't mean I plan to lose money. Just that I'm prepared to let others make the so-called "easy money", like buying into stocks I see as way over-hyped like Freelancer (but that seem to "keep going up" regardless of valuation)."

It's sound advice. If the market does keep rising indiscriminately, you can expect us to hold significantly more cash, hold more defensive stocks and, almost by definition, performance would trail a raging market. But that's a big "if". Is the market any more likely to be overtaken by animal spirits today than to fall 20%? It feels a lot more optimistic that it did two years ago, but that's because the market has already gone up. And that can change in an instant.

The simple fact is that you should always be prepared for underperformance, irrespective of the market. Our portfolios bear no resemblance whatsoever to any index and will often behave independently of the wider market. We buy businesses that we think are cheap. Sometimes that works out well in five weeks. Sometimes it takes five years. Sometimes we're wrong. Rest assured, we can underperform in any market, be it good, bad or ugly.

Underperformance and outperformance should be eliminated from the long-term investor's lexicon. Don't bother comparing yourself to anyone else at all.

Give yourself a decent timeframe in which to assess performance, say five years. At the end of that five-year period take a look at your absolute returns (or our absolute performance) and assess whether they are satisfactory or not relative to what you would have earned in the bank. Chances are you'll end up better than most without trying.

HOW TO VALUE A STOCK?

It's a question we frequently get asked. Many people intuitively grasp the concept that the stock market is simply a place where we can exchange small pieces of a business. 'Investing is most intelligent when it is most businesslike', wrote Benjamin Graham. The next logical question is, if you want to buy a stock for less than it is worth, how do you value it?

I was asked to do a presentation on this topic to members of the Australian Shareholders' Association in March. Before getting in to the nitty gritty, I told the audience that my family owns a farm and asked what questions would need to be answered if you were trying to value that farm. Answers came in faster than I could write them down. How many acres do they own? Where is it located? What sort of crops can you grow? How much stock do they own? Do they have any water licences? All sensible, necessary and legitimate questions.

Then I asked what questions you would need to ask were you trying to value Intelligent Investor's subscription business *Share Advisor*. Again the answers flooded in. How many subscribers does it have? What's the retention rate? How much revenue did it generate last year? What are the costs? Again, all perfectly legitimate questions that I would have asked myself.

Notice any similarities? Nope? Me neither. When valuing the farm, the questions were all about the assets. When valuing the publishing business, the questions were exclusively about the profitability (or otherwise) of the business. There was no overlap whatsoever.

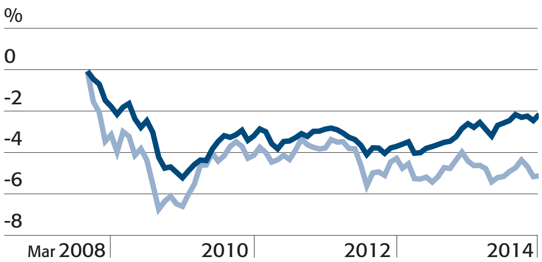
People get that valuing a stock simply involves valuing a part of a business. And, as could be seen with my two simple questions, they intuitively get that different types of businesses are valued using entirely different metrics. Yet we all want one simple formula for valuing a stock? Investing isn't that simple. There's no such thing as a right formula or a black box for valuing shares. The first step is to understand the business. Only once you understand it can you work out the best way to value it.

There's no such thing as a right formula or a black box for valuing shares. The first step is to understand the business.

HAS AUSTRALIA 'DECOUPLED' FROM CHINA?

Chart 1 is a reproduced version of one published by *Business Day* in the last week of March. It shows how closely the Australian Stock market tracked the fortunes of the Hong Kong China Enterprises Index over the past seven years. Given how closely Australia's commodity–driven economy is linked to China's commodity–intensive growth, the theory went, a sneeze in the Chinese economy meant the Australian share market caught a cold. Until twelve months ago that is.

CHART 1: S&P/ASX ALL ORDS INDEX VS HANG SENG CHINA ENTERPRISES INDEX



S&P/ASX All Ordinaries Index (^XAO)
Hang Seng China Enterprises Index (^HSCE)

Source: Capital IQ

As you can see in Chart 1, the Australian share market has gone ahead in leaps and bounds, despite more poor performance from the Chinese market.

China investors have good reason for concern. Growth in the world's second largest economy is falling faster than most observers had expected. The crackdown on corruption is landing some high profile scalps, to the extent that ex-president Jiang Zemin has called for the crackdown to be reined in (a bit like telling Eddie Obeid to get back into Parliament because his absence is making it too difficult to get anything done). The country's shadow banking sector is showing signs of stress, with a number of quasi defaults on popular wealth management products. And a small bank in the real banking sector experienced an old fashioned bank run during March.

Yet the Australian market seems to have 'decoupled' itself from Chinese concerns. House prices have surged across the country, employment markets have been surprisingly strong and consumers have been spending merrily. Investors have become increasingly confident that the lucky country can sail through another external crisis the same as it has the Asian financial crisis of 1998 and global financial crisis of 2008–9.

Can it? Whilst hoping so, I have my doubts. If we're right about China, the fall in commodity prices and associated mining activity has a long way to go. We'll be treading very carefully for a few more years yet.

INTELLIGENT INVESTOR SOLD TO AUSTRALASIAN WEALTH INVESTMENTS

After almost a decade of ownership, the shareholders of Intelligent Investor (including me) announced during March that we have agreed to sell the publishing business to ASX-listed Australasian Wealth Investments. The funds management business is not part of the sale and, while you will notice some significant cosmetic changes down the track, the only meaningful implication for us is a positive one. A contributing factor to selling the rest of the business was ensuring that I can devote 100% of my time to the funds management business and not have the distraction or stress of being a director and shareholder of the larger group.

The home we have found for the rest of Intelligent Investor is one we are very happy with and the two businesses will maintain a close relationship. But the Intelligent Investor name and brand will stay with the publication so Intelligent Investor Funds, as a name, is going to disappear in the not-too-distant future. You'll hear plenty about it prior but don't be too surprised if you see a quarterly update with a new name and logo by year end.

Despite a touch of sadness similar to that of seeing a child grow up and leave home, the sale will allow us to focus on what we love and ensure we have the best possible chance at success over the decade ahead.

As always, any questions or queries email them through to steve.johnson@iifunds.com.au or call us on (02) 8305 6050.

Kind regards,

Steve Johnson
Chief Investment Officer
Intelligent Investor Funds Management

International Fund

March was the month we had to have eventually. The MSCI World Index dropped 3.1% and the Fund fell 4.6%.

FUND FACTS

Fund commenced	8 Feb 13
Minimum investment	$20,000
Monthly investment	Min. $200/mth
Income distribution	Annual, 30 Jun
Applications/redemption	Weekly

UNIT PRICE SUMMARY

Date	**31 March 2014**
Buy price	**$1.3391**
Redemption price	**$1.3284**
Mid price	**$1.3337**
Portfolio value	**$53.6m**

"The Fund has topped up several existing US and European positions during the quarter, acquired a new European oil services business and is currently exploring the matryoshka doll that is Russia.

The Fund's large cash weighting offered no protection, as the fall in both the index and the Fund was mostly caused by a rampaging Australian dollar (as regularly disclosed, surplus cash is mainly held in foreign currencies for diversification benefits). The Fund's specific fall is mostly attributable to the 14% fall in the stock price of Italian small cap **B&C Speakers** (discussed below).

SUMMARY OF RETURNS AS AT 31 MARCH 2014

	INTERNATIONAL FUND (%)	MSCI ACWI IMI (%)
1 MONTH RETURN	–4.64	–3.11
3 MONTH RETURN	–1.45	–2.19
6 MONTH RETURN	12.97	9.63
1 YEAR RETURN	35.23	31.72
SINCE INCEPTION* (PA)	29.22	28.20

On average, value is getting harder to come by. But the Fund has topped up several existing US and European positions during the quarter, acquired a new European oil services business and is currently exploring the matryoshka doll that is Russia. The important details are outlined next.

DIVING DEEP FOR VALUE

There's a specific kind of value opportunity that comes around from time to time in businesses with high fixed costs and cyclical revenues, particularly if that revenue is derived from competitively tendered contracts that can be badly mispriced and last for years. The unwise buy and sell applying a multiple to any one year's earnings, assuming this year's results, good or bad, are a harbinger of years to come.

A smarter approach is to expect that, say, one year in five is going to be terrible and to price that into your valuation. When the stock price gets too cheap - generally when that one year in five comes around and the unwise are jamming the exits - that's the time to load up. Long term Intelligent Investor subscribers might remember the Leighton bargain buy of 2004, after the company stuffed up the pricing on the Southern Cross station development in Melbourne.

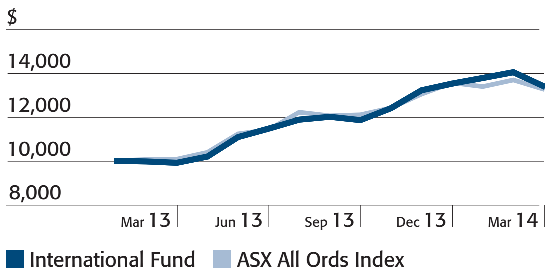
The newest addition to our mini energy portfolio, offshore services provider **Subsea 7** S.A. (OB:SUBC), is another example. The name might ring a bell—it's the former parent company of **Veripos Inc.**, a standout investment of 2013 that was taken over recently. In many ways, Subsea 7 echoes our investment in Veripos, although don't expect such a rapid or spectacular resolution.

Both companies combine strong operating businesses with attractive corporate governance. Both are headquartered in the UK but are listed in Norway. Whereas Veripos was a small, unknown company whose solid performance was new to the market, Subsea 7 is a large company with a long history. But its underlying intrinsic value is currently being obscured by temporary factors. There is much to like about the stock.

Subsea 7 is the largest pure-play oil & gas engineering and construction (E&C) company in the world. Think of it as a giant, energy-related industrial contractor. It bids on projects, designs and develops plans to meet the scope of work, then carries out the actual installation. Most of its projects involve constructing large underwater hydrocarbon-producing platforms.

Its fleet of more than forty large, highly sophisticated, specialised marine vessels and a payroll in excess of 2,000 engineers with deep, irreplaceable industry experience form the backbone of the operation. Clients include oil giants like **BP** and **Shell**, smaller independent exploration and production companies and national oil companies like **Petrobras** in Brazil.

CHART 1: COMPARISON OF $10,000 INVESTED IN THE INTERNATIONAL FUND AND THE MSCI ACWI IMI (FEB 2013–MAR 2014)



Source: Capital IQ, Dec 2013

The company competes head-to-head with only two firms: French group **Technip** and Italian company **Saipem**. Considering the nature of the work, one can see why this industry lends itself to competitive concentration. The projects Subsea 7 undertakes are technically complex, involving specialised equipment and often utilising innovative engineering techniques and processes developed in-house. There's also a geographic element to the moat, an upstart cannot afford the necessary presence in so many markets. Project costs can range from tens of millions to billions of dollars.

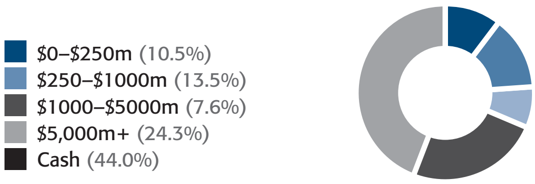
Put yourself in the customer's shoes for a moment. Say you are high in the ranks at Shell and are in charge of a $1bn budget for a complex speculative drilling project in ultra-deep water off the coast of Africa. Would you consider hiring a firm who has not completed similar projects before? We doubt it. For one, if they screw up, you're going to lose your job.

Because reputation and actual delivery matter, and because economies of scale are important, experienced players win all the major contracts. The industry has not seen a new competitor in years. With almost 50% market share globally, Subsea 7 is the largest of the three major deep water E&C companies. It is well positioned to lead for a very long time.

> ***While correct assessment of the competitive dynamic is an important factor in successful investing, price is always crucial.***

But the appeal is not confined to industry structure alone. While correct assessment of the competitive dynamic is an important factor in successful investing, price is always crucial. The company has had a few things go wrong, hence the opportunity.

CHART 2: PORTFOLIO DISTRIBUTION ACCORDING TO MARKET CAP



Subsea 7's financial results for 2013 likely represent a low point. The company engages in projects that take 2–3 years to complete. As a result, the profitability of signed contracts doesn't typically get reflected in the financial results in a timely manner. Poor contracts, the ones you wish you could go back in time and cancel, can dampen the company's earnings for a few years. Subsea 7 currently has a number of these types of contracts that were signed in 2010-2011, a weak period for the industry. As a result, profit margins have been hammered.

One deal, Brazilian project Guara Lula, has been particularly challenging. It's resulted in billions of dollars in unexpected delays and charges. But current investor focus is too short term and overly concerned with one stuff up. This project and others like it are coming to a finish and rolling off the books. They are being replaced by more recent contracts signed on more preferable terms, in part because the E&C companies have become twice-shy on pricing. This is a potential catalyst that we believe will elevate Subsea 7's earnings power.

From a valuation standpoint, Mr Market is offering Subsea 7 at attractive terms. Trading below book value and with a price-to-earnings ratio of less than 10 times forecast earnings, the market seems to believe that Subsea 7 either lacks growth opportunities or is an inferior business. We disagree with both implications.

Oil production volumes from mature regions are declining, and North American shale plays are likely to see rapid decline rates. We believe that more oil will need to be extracted from deep water and ultra-deep water basins around the world in the long run. Subsea 7 is positioned perfectly for this trend. With this longer term tail wind and near-term fundamentals improving, Subsea 7 is too cheap. Oh, and did we mention that the Chairman owns 20% of the stock? Icing on the cake.

GERMAN DIY STILL ON SALE

An initial investment in German do-it-yourself (DIY) business Hornbach was highlighted in the *March 2013 quarterly letter*. While that initial investment was in the property-owning parent entity **Hornbach Holding AG** (DB:HBH3), we have recently added to the exposure by buying shares in the related operating business, **Hornbach Baumarkt AG** (DB:HBM). While there are some mild differences between the two companies' exposures, think of it as one investment which together now makes up almost 5% of the portfolio.

Hornbach Baumarkt operates 92 DIY megastores in Germany, and another 49 in other (mainly affluent) parts of Europe. The upside/downside dynamic is currently lopsided in the buyer's favour.

The stock trades at a very modest 8% premium to net tangible assets (NTA). But the 37 company-owned sites are on the books at cost, and most have been held for several decades. If we revalue those properties using fairly conservative assumptions, Hornbach Baumarkt is trading a discount to NTA of perhaps 15%. The market is hinting that the stock is worth more dead than alive.

But the company is worth more than liquidation value, perhaps significantly so. The German DIY-market has been very competitive for decades, and hyper-competitive the past five years. Hornbach's earnings before interest and tax (EBIT) margins in Germany have averaged barely 2% the past decade, and have been less than 2% the past four years. That's probably industry-leading or close to. In comparison, Hornbach's operations elsewhere in Europe have achieved average EBIT margins around 6.5% the past decade despite Europe's woes, Lowe's and Home Depot in the US achieve 7–10% EBIT margins, and Bunnings would likely be 12% or more. The difference is mainly because the competitive landscape is far less consolidated in Germany than the US or Australia.

SUMMARY OF HOLDINGS

STOCK	COUNTRY	PORTFOLIO WEIGHTING (%)
JAPANESE PORTFOLIO OF NET-NETS	Japan	5.9
B&C SPEAKERS	Italy	5.4
AMERICAN INT'L GROUP	US	5.2
AMERICAN EXPRESS CO	US	5.0
GOOGLE INC CLASS A SHARES	US	4.9

Yet despite these razor thin margins, over the past decade Hornbach Baumarkt has grown its total store network from 102 to 141 at significant cost (while increasing company-owned property from 35 to 37 stores), repaid €400m of net debt and paid €141m of dividends. And it's done that almost exclusively from retained profits, issuing just €25m of stock over the decade (to put this all in perspective, the current market capitalisation is €940m). Imagine what it could do if margins improved in Germany?

The downside appears minimal and there are many ways to win from here. The profit figure for the year ended 28 February 2014 hasn't yet been released. The consensus broker estimates suggest earnings per share (EPS) of €2.27, putting the stock on a forecast price-to-earnings ratio (PER) of around 13.

If the broader European economy came out of its depressive funk, the business would increase sales and earnings considerably. If German DIY operators stop trying to behead each other with chainsaws from aisle 6, the business will gush profit due to improved margins. As reported in the *January 2014 letter*, the collapse last year of the company that owned competitors **Max Bahr** and **Praktiker** creates progress on the consolidation front. From that insolvency alone, about 5% of German DIY floor space has moved to stronger hands (including 4 sites leased by Hornbach, currently being redeveloped and rebadged) and another 5% of industry floor space has left the DIY market for good.

There are several smaller wins on offer too, even if the environment remains hyper-competitive and overall sales depressed.

Hornbach Baumarkt and Hornbach Holdings both offer a compelling margin of safety with plenty of upside potential.

At last count the company had €434m of cash (earning almost nothing in interest) and gross debt of €383m (on which it pays interest). So it's in a net cash position, but an inefficiently structured one. The group could repay debt, reducing its net interest bill and boosting EPS and dividends. Or it could invest some of the cash in new stores, either greenfield sites or locations acquired from troubled operators like Austrian group **Baumax**, also boosting earnings and dividends in the process. Or it could return a hefty chunk of cash, easily €5 and perhaps as much as €10 a share (versus a current share price of €29.65) with very little impact to future EPS or dividends and without stretching the balance sheet. Or it could consider buybacks, again boosting EPS and dividends.

Hornbach Baumarkt and Hornbach Holdings both offer a compelling margin of safety with plenty of upside potential. Combined, the position is the Fund's fifth largest holding.

EUROPEAN RESULTS

One of the Fund's largest individual positions, Italian small cap **B&C Speakers** (BIT:BEC), fell 14% in March. The first influence was the end to the indiscriminate buying that pushed the stock up 19% in February. The second was a rather mediocre results announcement.

In the fourth quarter of 2013, several speaker orders were pushed back from December into the new year, and there was also a general slowdown in business. So revenue and earnings growth for the year were below expectations (despite a 5% and 14% rise, respectively). But there is nothing to be alarmed about.

Management expects 10–11% revenue growth in 2014—helped by strong growth in China and increased Brazilian business related to the World Cup—and is hopeful the company can achieve earnings of around 50 euro cents per share. That puts the stock on a forecast earnings multiple of a little over 13, and a prospective yield in excess of 5%.

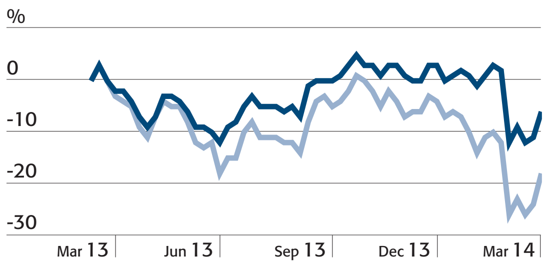
Flughafen Zürich (Zurich Airport) (SWX:FHZN) reported its results for the year ended 31 December 2013. Total passenger growth was an anaemic 0.3%, but this was because a fall in transfer passengers hid a 2.2% growth in origin/destination traffic (generally the more valuable kind). Over the medium term, we expect overall passenger growth of a few percent per year.

Highlighting the inbuilt operating leverage in an airport, that passenger growth translated to 2.8% revenue growth and a 5.8% increase in net profit. The company continues to pay down debt in advance of some value-adding investment to come over the next few years and is conservatively financed. The flipside of all this debt repayment is the lowly dividend yield of 1.7%, but the capacity (and we think intention) for a substantial dividend increase in the next few years is there. The stock rose 1.9% in March and is up 14% on the Fund's average purchase price. Steve and Gareth have a 5-hour layover scheduled at the airport in May, to be filled with a tour of the facility and a meeting with management.

RUSSIAN BEAR

At first glance, 'war' and 'investment opportunity' don't seem to belong in the same sentence. But value investors have long known they can go together. Investing great Phil Fisher's book *Common Stocks and Uncommon Profits* contained an entire chapter titled *Don't be afraid of buying on a war scare*.

CHART 3: PERFORMANCE OF THE RUSSIAN STOCKMARKET OVER 1 YEAR



Russia Micex Index (RUB)
RTS Index (USD)
Source: Capital IQ

The Crimean peninsula has been a part of Ukraine since Soviet leadership transferred it from Russia in 1954. But it has a majority Russian population. After the recent Ukrainian uprising, the region had a referendum (considered a sham by the West) to re-join Russia, and more than 90% of the voters ticked 'Da'. Subsequently, Russia annexed the peninsula. There's a risk of similar moves in other parts of Eastern Ukraine with an ethnic Russian majority and other parts of the former Soviet empire—Transnistria and sections of several Baltic states—that share similar demographics, though President Putin has generally talked down such issues.

The situation is complex. More complex than the West's typical 'good vs evil' narrative, and more complex than Putin's claims that the West are the troublemakers here, and Russia is just bowing to the will of people in Crimea and taking back what was always hers anyway. But the immediate consequence is that the US and Europe are placing some targeted sanctions on Russia and a few handfuls of rich Russians with close ties to Putin (What do you call a rich Russian without close ties to Putin? A poor inmate). There's risk of escalating sanctions, scuffles and even war.

Despite a recent bounce back, the Russian bellwether Micex index is down about 10% since its October peak. And that's priced in Roubles, the local currency, which is also down about 20% against the Euro over the past year. In internationally-priced currency, this is a major bear market.

When others are running away is when value investors have an obligation to ignore that knot in their stomach and at least take a closer look.

Russian 10-year bonds are trading on yields around 9%, up from less than 7% a few years ago. And perhaps that doesn't tell the full picture. Five Government bond auctions have failed since the Crimean incursion, and the government has been forced to seek funds internally from Russian banks and oligarchs. When Putin says jump, you know what their answer is.

The prospect of sanctions, escalations or war are serious concerns. Further downside is a real possibility. But there are also a few 'birds in the hand' worth counting.

For one, Russia isn't terribly dependent on the rest of the world. While exports as a percentage of GDP are high at around 30% (versus 21% for Australia), almost 60% of those exports are oil and natural gas-related, and most of the rest dominated by commodities both hard and soft. Most of these commodities are in high demand and fungible, so if the US and Europe don't want them, China and India will (perhaps at a small discount), though we don't ignore the fact that any such transition could be jarring.

Besides, if the Russia to Europe gas pipelines were shut down by sanctions, the pain would be far greater for shivering Dutch and German pensioners than the Russian oligarchs and political class. So we're sceptical of seeing anything on that front in the short term, though couldn't rule it out.

Another bird in the hand is the cheapness of the stock market. Russian stocks are changing hands on price-to-earnings multiples of 4–5, versus 15 and greater in the US and Europe. It's cheap, even allowing for 9% bond yields and the potential crimping of profits due to sanctions. 'Corporate governance' doesn't seem to have a direct Russian translation, but some companies are certainly better than others. And a low enough price can forgive a multitude of sins.

The Fund hasn't made any investments yet but is searching along several broad fronts. Firstly, there's the European consumer goods company that's been on the watch list for some time. It generates one-third of sales from Russia and former CIS states and is down 25% since Christmas – not 'Russian cheap' but a final capitulation would put it in buying range. We're taking a closer look at several London-listed Russian stocks, chiefly ones that seem immune to sanctions and are well-run. And we're also doing a broader sweep of Russian stocks, looking for potential diamonds in the rough.

CURRENCY EXPOSURE

CURRENCY	EXPOSURE (% OF PORTFOLIO)
USD	52.0%
EUR	15.6%
NOK	10.9%
GBP	7.4%
CHF	6.2%

Value investing means finding bargain stocks others hate, and that can include when they hate whole geographies at once. When others are running away is when value investors have an obligation to ignore that knot in their stomach and at least take a closer look. That's how investors like Peter Cundill and John Templeton made their mark.

It might amount to nothing, but the Fund is currently running the rule over Russia. Of course, no investment around this concept will be low-risk, and position sizes will reflect that.

Value Fund

The Value Fund returned 0.2% in the March quarter, worse than the ASX All Ordinaries Accumulation Index which rose 2.2%.

FUND FACTS

Fund commenced	31 Oct 2009
Minimum investment	$10,000
Monthly investment	Min. $100/mth
Income distribution	Annual, 30 June
Applications/Redemption	Weekly

UNIT PRICE SUMMARY

Date	31 March 2014
Buy price	$1.4807
Redemption price	$1.4689
Mid price	$1.4748
Portfolio value	$52.1M

The Value Fund's performance, as usual, was driven more by individual company news rather than any overarching themes or developments.

The Value Fund's performance, as usual, was driven more by individual company news rather than any overarching themes or developments. The Fund's investments in **Service Stream** (SSM) and Enero Group (EGG) were the major positive contributors and recent developments are discussed below. Those gains were offset by share price falls in **Vision Eye Institute** (VEI), **RNY Property Trust** (RNY), **Infigen Energy** (IFN) and the collection of mining services businesses.

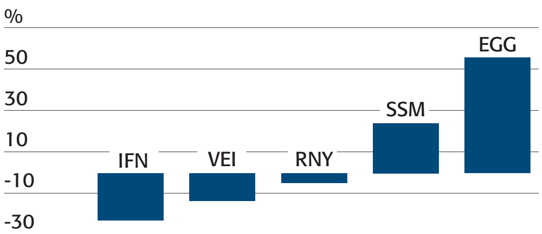
SUMMARY OF RETURNS AS AT 31 MARCH 2014

	VALUE FUND (%)	S&P ALL ORDS. ACCUM. INDEX (%)
1 MONTH RETURN	–1.28	0.25
3 MONTH RETURN	0.24	2.20
6 MONTH RETURN	3.02	5.70
1 YEAR RETURN	24.64	13.19
2 YEAR RETURN (PA)	27.80	15.47
3 YEAR RETURN (PA)	19.93	7.74
SINCE INCEPTION*(PA)	14.05	8.01

BOARD DOES SHAREHOLDERS A DIS-SERVICE

Developments at Service Stream weren't pleasing despite the positive contribution to Fund returns. This contracting business provides services to large utilities clients like **Telstra**, NBN Co and **AGL** and recently announced a capital raising to repay debt and fund working capital. The company's problem child – its fixed telecommunications business – has been bleeding for the past few years but also has the most potential given the huge increase in demand for high speed broadband infrastructure (NBN or not). Raising some capital to repay debt and enable the company to take advantage of these opportunities makes sense. The way the Board structured the deal does not.

CHART 1: VALUE FUND MAJOR PORTFOLIO MOVERS



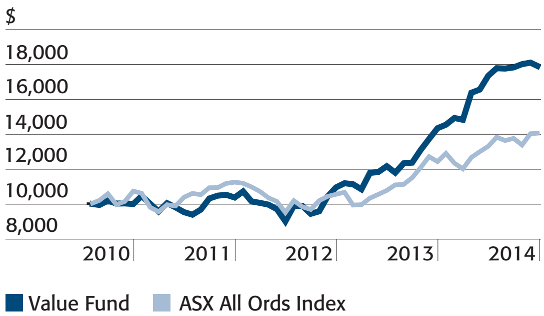
Source: Intelligent Investor Funds Management

Nearly half of the total $20m cash to be raised by Service Stream was done by placement to entities associated with the major shareholder, Thorney International, the Pratt-family investment vehicle run by Melbourne businessman Alex Waislitz. As a result, the combined Thorney-entity shareholdings will increase from less than 20% to more than 28%, in effect handing up control of the company.

There's been no wrong done by Thorney. It put a deal forward that fixed the company's problems and served its own interests. But the Service Stream directors have failed in their duty to look after all shareholders. Whilst the board has a different view, it's our opinion that there were other ways of raising the same amount of capital that didn't have the same control implications. A controlling interest in this business is worth a significant premium and the Board has given it up for a pittance.

Despite actions taken by us to block or restructure the deal on your behalf, the vote went through comfortably in March and we are going to have to live with the consequences.

CHART 2: COMPARISON OF $10,000 INVESTED IN THE VALUE FUND VS THE ASX ALL ORDS INDEX



Source: Capital IQ

Service Stream shares rose 24% in the quarter to close at $0.23. That's comfortably above the $0.18 per share at which the remaining half of the $20m is being raised from all shareholders. The shares are still good value and, barring anything extraordinary, the Fund will take up its rights and bid for additional shares in the shortfall.

ENERO GROUP TURNING THE CORNER

Half-year results from Enero Group (EGG) weren't exactly fantastic – revenue fell yet again and profit was a measly $1m – but operating margins were a little better at 8.1%. That's still around half the margins Enero's peers in advertising and marketing make, but the share price, which had been factoring in the worst, roared up 56% to $1.00. The shares have now risen 170% over the past 12 months, erasing some of the Fund's earlier losses with this company.

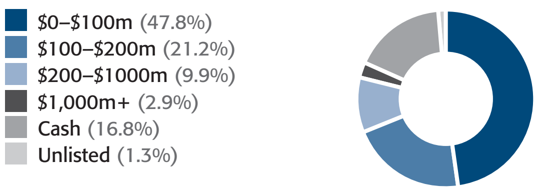
In discussions with management after the results they were at pains to try and dampen expectations, indicating they would be hard pressed to repeat the first half performance in the second half of the year. It seems the bulk of management attention remains on the regular troublemaking agency Naked, which continues to rack up losses. Chief executive Matthew Melhuish provided a few insights on the work being done to improve margins, most of which is happening at quite a granular level.

Marketing agencies should run at 15% operating margins as a rule of thumb, and according to Melhuish this is generally arrived at after deducting 65% billable staff expenses and 20% overheads. The overheads in Enero's agencies are already relatively lean and there aren't many further cuts to be made, it is the billable part of the business that needs to be run tighter.

This involves being stringent in the use of consultants for outsourced work and monitoring utilisation reports tightly to ensure that staff are billing efficiently. That's apparently not been a strong area for the stragglers among Enero's agencies, many of which until recently didn't even have regular reports available for review.

> ***The company's property division, DTZ, is the jewel in its crown. Its quality and growth has been hidden and hindered by the Australian engineering business.***

CHART 3: PORTFOLIO DISTRIBUTION ACCORDING TO MARKET CAP



Melhuish is close to turning the corner with this business but, with the stock price up so much recently, it isn't hugely undervalued any more. Supposing Enero can repeat its first half result, it probably trades at around 15 times economic earnings (arrived at after making some adjustments for amortisation and excess cash), which isn't particularly cheap for a business like this. If the company can turn Naked around or sell it for a decent price shareholders will still do nicely, but there are risks and the odds are less skewed in our favour than previously.

HANSEN MEETS THE BILL

On the topic of billing, the Value Fund took a stake in software provider **Hansen Technologies** (HSN) during the quarter. Hansen's core business is to provide billing and customer care services to utility and telecommunications companies. It's a nice little business. The market for billing solutions is divided into those provided by huge corporations such as **Oracle** as part of larger enterprise-wide software platforms, and specialists such as Hansen that are dedicated to billing.

At the specialist end of the market, the software is designed to be highly customisable. Bills need to go out correctly and on time in order to keep customers happy and paying their bills and the mobile phone companies need the flexibility to offer a wide range of products and promotions – a trend that is very prominent in the marketing of mobile phone contracts, for example.

Because services are so integrated with the rest of their business, clients aren't likely to switch software unless they have a pressing reason to do so. For Hansen this means they have long relationships with customers and steady revenues, which affords the opportunity to earn nice operating margins, currently exceeding 20%. It also means, however, that it is difficult to pinch clients from competitors, so the opportunities to grow the business organically are limited. Expect only modest growth from existing operations.

The Fund picked up shares in Hansen for $1.20 through a block trade with the founding Hansen family, which has now reduced its ownership to 33%. That prices Hansen at around 15 times earnings, with a 5% dividend yield, which is very reasonable for such a high quality business.

There is also potential upside from acquisitions. Though it usually pays to steer clear of serial acquirers, managing director Andrew Hansen has proven astute at selecting small-to medium-sized software companies providing complementary services with similarly sticky customers. They then drive costs lower and ensure the client pays for everything that it can reasonably be charged for.

Over time these acquisitions have added considerable value to Hansen. The most significant recent acquisition, the $11m purchase of ICC, which provides Hansen access to the pay-TV billing market, looks very promising and the integration is reportedly going well. Acquisitions are likely to continue which offers growth, but also risk. A misguided acquisition is certainly high on our list of possible hazards.

A SELECTION OF STOCK HOLDINGS

STOCK	DESCRIPTION	WEIGHTING
HANSEN TECHNOLOGIES	Provider of billing and customer care software	8.4%
VISION EYE INSTITUTE	Ophthalmology clinics around Australia	7.8%
ENERO GROUP	International marketing agency	5.9%

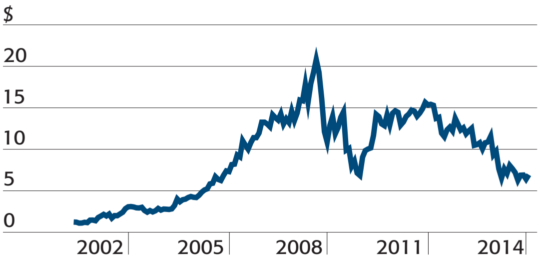
Hansen is now one of the larger investments in the Value Fund and it's a nice addition to the portfolio. The stock price finished the quarter marginally higher at $1.22.

PROFITING FROM UGL'S CROWN JEWEL

Another recent addition to the Value Fund portfolio is **United Group Limited** (UGL). It's been a wild ride for shareholders in this engineering and property services company. The share price rose from $1.25 when Richard Leupen took the reins as CEO in August 2000, to $21 at the peak of the mining construction boom and back to less than $6 in the subsequent bust. It wallows not far above that point today, with concerns about the amount of debt it owes and a shrinking mining services business worrying investors and analysts.

The company's property division, DTZ, is the jewel in its crown. Its quality and growth has been hidden and hindered by the Australian engineering business. DTZ offers a full range of commercial property services around the globe. Relative to competitors like **CBRE** and **Jones Lang LaSalle**, it is weaker in property sales and leasing but much stronger in property maintenance, a less lucrative but more stable business.

CHART 4: UGL STOCK PRICE FOLLOWING CEO LEUPEN'S APPOINTMENT



Source: Capital IQ

Under pressure to repay debt and resurrect the share price, the board made a decision in mid 2013 to demerge DTZ from UGL. By mid to late 2014, shareholders would own shares in DTZ and UGL and each company would be free to focus on its own future. Splits like this have worked well in the past. DTZ is a fantastic business and would thrive as a separately listed company and a standalone UGL also has the potential to be much more profitable than it is today.

This demerger is still being progressed but the board is now also considering outright offers for DTZ from private equity.

Complicating the demerger option is the company's debt load. It is perceived as too large to be borne by the two businesses on a standalone basis, meaning fresh capital would need to be raised as part of the split. A sale of DTZ would fix that problem and enable UGL to return a significant amount of capital to shareholders.

All well and good but only if they get a knock-out price for DTZ. This business is the main reason we own UGL shares and we would be happy owning it for a long time to come. Giving DTZ away cheaply and letting private equity take the spoils is not an adequate solution.

UGL's share registry includes well-regarded value investors such as Allan Gray and Caledonia. They should help ensure we all get the right result.

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