Funds Management
Quarterly Report
September 2013

INTELLIGENT INVESTOR
FUNDS MANAGEMENT

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Is this a stockmarket bubble?

At midnight on Tuesday, 1 October 2013, the US Government shut down. On Wednesday 2 October, 800,000 US Government employees didn't go to work because their employer refuses to pay them. On that day, the S&P 500 *rose* 0.8%.

If you were requiring any further evidence that this is a raging bull market, look no further. Markets around the world are running hot.

Whether it's Chinese property, US equities or Australian house prices, investors around the world are bidding up the prices of any assets that have the potential to deliver them a return in excess of absurdly low interest rates. The Australian stock market, as measured by the All Ordinaries Index including dividends, has returned 24% and 18% per annum in the past one and two years respectively.

In the same periods, the Intelligent Investor Value Fund has returned 43% and 39% per annum (the return since inception in late 2009 is now a very healthy 15% per annum, up from less than zero two years ago).

Mr Market, value investing doyen Ben Graham's personification of the collective mood of investors, is on a high. **Ingenia Communities**, a stock bought for the Value Fund at a 62% discount to its tangible asset backing, has raised almost $100m at or close to tangible asset backing in the past four months. Its current market price is a 35% premium (see page 10). There has been some change in the underlying business value, but most of the fivefold increase in the unit price is a result of a change in perceptions about the future.

TABLE 1: PERFORMANCE TO 30 SEPTEMBER 2013

	1 QUARTER	1 YEAR	3 YEAR	SINCE INCEPTION
VALUE FUND	17.04%	42.68%	22.14% pa	15.09% pa
ASX ALL ORDINARIES ACCUM. INDEX	10.78%	23.55%	8.65% pa	7.55% pa
INTERNATIONAL FUND	3.41%	–	–	18.64%
MSCI ACWI IMI	5.99%	–	–	21.07%

That is just one example close to home. Mr Market's mood has allowed US giant **Verizon** to raise $48bn of new debt—the largest commercial bond issuance ever—for the acquisition of Vodafone's share of the two companies' US joint venture. **Microsoft** agreed to buy **Nokia**'s handset business for €5.44bn. And the IPOs are coming thick and fast including, reportedly, the Australian listing of Dick Smith for as much as $600m, more than six times the price private equity paid to buy the business from **Woolworths** less than 18 months ago.

Everything is a bubble these days

Given the strike rate seems to be nine failures for every one success, it's hard to work out who buys private equity floats. Perhaps fund managers afraid of missing out. Perhaps gullible retail investors only just coming back to the market. They certainly aren't the same investors who were mopping up Ingenia at half book value three years ago. Today's market is being driven by a more optimistic type.

The question is whether we're entering bubble territory. Should we be selling up and waiting for the bargains to return?

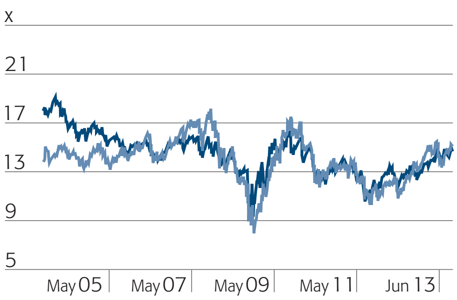
As *Economist* blog *Free Exchange* put it, "Use of the term has grown so fast and loose that nearly any sustained rise in prices in any market gets the bubble label at some point." With memories of 2008, 2009 and 2011 so fresh in investors' memories, it's not surprising that we're all looking over our shoulders for the next financial market collapse.

Taking a step back, though, there are few signs of an outright bubble for equities. The Charts 1 and 2 show a couple of simplistic valuation metrics for both the ASX All Ordinaries Index and the S&P 500, a US market index. On both price to earnings multiples and price to book multiples, both indices are within a sensible range of long-term averages.

There are arguments for why the multiple should be either side of long-term averages. Jeremy Grantham of *GMO* thinks that profit margins, and hence earnings, are a bubble of their own. Yet record low long-term interest rates would suggest the multiple should be higher than usual. Trillions of dollars of newly created money could have a raft of negative

If you were requiring any further evidence that this is a raging bull market, look no further. Markets around the world are running hot.

CHART 1: AVERAGE PRICE-TO-EARINGS RATIO



S&P 500 Index   S&P/ASX All Ordinaries Index
Source: Capital IQ Forward P/E

CHART 2: AVERAGE PRICE-TO-BOOK RATIO

S&P 500 Index   S&P/ASX All Ordinaries Index
Source: Capital IQ Forward P/E

unintended consequences. Much of the developed world is showing some signs of sustainable recovery from recession.

Each argument has its merits, which in itself suggests this is probably not a bubble (when you get nonsensical arguments on one side of the debate—like using eyeballs as a valuation metric—you know you are in bubble territory).

Investors should obviously temper their expectations. Two years ago equities were priced to provide a long-term return of 8–10%. Today that number is more like 6–8%. And markets could easily fall significantly again. We would welcome that as an opportunity to put some of our excess cash to work, but on the whole there is no reason to be paralysed by pessimism.

The market might not be absurdly overvalued, but it isn't leaving much behind, particularly in Australia and the US. Rather than a combination of overpriced and underpriced stocks making for a reasonably priced market, almost everything trades at a fair price. Outright bargains are few and far between.

> *"Two years ago equities were priced to provide a long-term return of 8–10%. Today that number is more like 6–8%. And markets could easily fall significantly again.*

Fed tapers, pirouettes and tapers again, perhaps

In May the US Federal Reserve began making noises about reducing its US$85bn per month of quantitative easing, tapering it down to zero over the next 12 months and then potentially beginning the process of increasing interest rates towards the end of 2014.

That sent bond markets and some foreign-capital-addicted emerging market economies into a tailspin.

In the months that followed Ben Bernanke's tapering announcement, the 10-year government bond rate almost doubled, from 1.7% to roughly 3%. US bond rates are used as a benchmark for almost all other asset classes, so when they rise, asset prices fall (or at least stop rising). When asset prices fall, particularly house prices, people spend less and that has an impact on the real economy. Which is why, in September, Bernanke performed an abrupt about face and put tapering on hold.

CHART 3: YIELD ON 10 YEAR US TREASURY BONDS

Source: Capital IQ

Unfortunately a recovery built on rising asset prices and increasing debt with which to fund consumption is not particularly sustainable. Haven't we seen that story end in tears before? The US economy needs business investment, jobs and more business investment. And it's not an increase in interest rates that is holding that process back.

No company has a business plan that works at a 2% cost of funding but doesn't work at 3%. The recent increase in long-term rates would not have put one business plan back on the shelf (excluding, perhaps, those of a few aspiring hedge fund managers).

A return to more 'normal'[1] monetary policy has the potential to impact positively on the economy. With the Federal Reserve, an arm of the US government, spending US$85bn a month to buy its own debt securities, it's no surprise that those who hold the corporate purse strings remain nervous. The Fed can end its bond purchasing *and* keep interest rates sensibly low, simply by telling the market that they intend to keep short-term rates low for the foreseeable future.

Long-term rates would be unlikely to rise much further than the current level of 3%. That might break a few highly leveraged speculators. But it might also give the real economy the vote of confidence it needs.

China prints any GDP it likes

The September quarter was also marked by a bout of renewed optimism about the prospects for the Chinese economy and suggestions that, once again, the China bears are eating humble pie. Yes, we are ensconced in the bear camp. And we will be personally relieved to eat some humble pie if the Chinese economy starts growing in a sustainable fashion. But there is no evidence yet that that is the case.

Gross domestic product, or GDP, is a measure of activity in an economy. It tells you nothing about the composition of that activity. If your house burns down and you rebuild it, the construction of the new house will add to GDP in the period in which it is built. Of course, you don't need to be Ross Gittens to know that a house burning down can't be good for the long-term health of an economy.

The pain will be felt in future periods, when the funding cost reduces future consumption or investment (the funding cost will be either interest on debt or forgone earnings on investments that have been sold).

[1] Amongst others, Jim Grant of Grant's Interest Rate Observer doesn't think there is anything normal about the Fed manipulating the short term interest rate, let alone the long term rate.

The same principle applies to an economy as a whole. Which is why we have been arguing for the past few years that it is not China's GDP growth per se that is unsustainable. It is the composition of that growth that is the problem. It is overly dependent on investment, the investment is being funded by debt, and the investment is not generating enough return to fund the cost of debt. As a result, debt levels have been rising much faster than GDP for years.

Every time the authorities attempt to turn the debt spigots off, GDP growth slows sharply. So they turn them back on.

In August a number of Chinese economic indicators, including factory orders, property prices and exports turned sharply upwards, suggesting third-quarter GDP growth is going to exceed expectations. That is not surprising. Debt extended doubled during August to 1.57 trillion yuan. According to Bloomberg, 'new yuan loans from banks accounted for about 45 percent of the total, down from July's 87 percent, as non-traditional credit played a bigger role.'

Growth is back because credit is back, bigger and worse than ever before.

Michael Pettis, a professor at Peking University's Guanghua School of Management, is tired of repeating himself and we are tired of quoting him. But his latest missive sums the situation up nicely:

"I really can't write too much more about this without sounding repetitive. There is nothing in the most recent batch of numbers to suggest that anything at all has changed in the Chinese economy. GDP growth is up because credit is up even more, and this is confirmed by reports that the surge on growth has been pretty narrowly limited to heavy industry and the state-led sectors, which tend to have the easiest access to credit and the least concern about the profitability of investment. Until Beijing is truly able to get control over credit expansion, and to tolerate the much slower GDP growth that will inevitably result, growth rates will stay in the 7–8% range and fluctuations within that range will mean very little.

> *"Growth is back because credit is back, bigger and worse than ever before.*

There is no reason China's economy needs to come unstuck in the next few months or years. But the longer it grows in this fashion, the larger the inevitable correction needs to be. It is worth reiterating once more, too, that when the correction comes, it is unlikely to be a violent cleansing, as you might see in the US. It is much more likely to be a Japanese-style decade of zombie banks and sub-par growth. Until then, though, it seems the Chinese are intent on letting the good times roll.

Melbourne and Sydney roadshows

We welcomed many new investors during the past three months and raised more than $14m from both new and existing investors. Welcome to your first quarterly report if you are new, and thank you if you have added further to your investments with us.

Whether you are new to the fold or have been with us from the beginning, the message from this report is hopefully clear. The Value Fund's 17% return in the September quarter would be an excellent result for a whole year, let alone three months. We are striving to protect your capital and are constantly searching for (and occasionally finding) new opportunities. But in the past 12 months in particular, the gap between price and value has narrowed appreciably.

The bargains will return and we will be holding plenty of cash when they do, but for now we suggest you temper your expectations.

To hear about a few of the opportunities we are finding, come and join us at this year's truncated roadshow. We'll be joined by **Platinum Asset Management**'s Kerr Neilson in Melbourne on 21 November and **Magellan Financial Group**'s Chris Mackay in Sydney on 26 November. More information on tickets will be available soon but keep the nights free if you can make it to either or both of those events.

International Fund

The International Fund's unit price fell 1.3% in September, contrasting with a 0.4% rise from the MSCI Index*. September's underperformance deserves the same explanation as August's outperformance—a lack of exposure to emerging markets currencies. Underperformance of 2.6% for the 3-month period to 30 September 2013—an increase of 3.4% for Fund investors versus 6.0% from the index—is partly caused by the aforementioned lack of emerging market currency exposure, but mostly by having a pile of surplus cash in a raging bull market. Despite generally rising markets, we've found some specific bargains and have continued putting your money to work. The Fund is now two-thirds invested in stocks and one-third in cash, up from a 50:50 split three months ago.

TABLE 1: SUMMARY OF RETURNS AT 30 SEP 2013

	INTELLIGENT INVESTOR INTL FUND	MSCI ACWI IMI
1 MONTH	–1.27%	0.39%
3 MONTHS	3.41%	5.99%
6 MONTHS	19.69%	20.15%
SINCE INCEPTION*	18.64%	21.07%
PORTFOLIO VALUE	**$30.8m**	

*8 February 2013

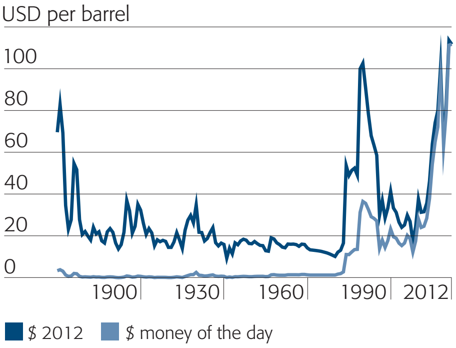
TABLE 2: UNIT PRICE SUMMARY

DATE AS AT	30 Sep 2013
BUY PRICE	$1.1854
REDEMPTION PRICE	$1.1759
MID PRICE	$1.1807

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

CHART 1: CRUDE OIL PRICES 1870–2012



Source: BP Statistical Review of World Energy, June 2013

Striking bargains in the oil patch

We don't go out of our way to find themes to exploit. Our focus is finding cheap stocks, in whatever sector they happen to reside. But on occasions markets become so enthusiastically wedded to a theme that they allow whole sectors to become mispriced. If an ill-found shift in sentiment allows good stocks to get unfairly penalised for not being the flavour of the month, even bottom-up investors can become thematic. This is taking place today with energy. The oil futures 'curve' currently projects a 16% decline in the price of oil over the next two years. Energy stocks have suffered disproportionately and currently trade collectively at 12.5 times earnings, well below the overall market.

Investors have gravitated toward a number of trends that they believe will shape the oil market over the coming years. At a high level, they have adopted a 'reversion to the mean' perspective; oil prices are elevated compared with their long-term averages and should revert downward over the longer term. The most simplistic case one can make for this position is to look at crude oil prices (Chart 1).

The last time the world saw oil prices this high (as measured in 2012 US dollars), disco reigned supreme. By the mid 1980s, though, we were awash with oil and prices had fallen dramatically.

One could observe the spike in prices this past decade and assume a similar correction is overdue. And indeed there are market forces in the works that suggest this could happen, mostly related to the US shale gas revolution and the impact of dramatically lower gas prices on competing sources of energy.

But the supply/demand dynamic in today's global economy differs tremendously from that of the 1970s. During the 1960s and 1970s global energy markets produced, on average, 4% more oil than the world needed. By 1980, a global surplus of greater than 32 million barrels of oil per day (mbpd) was accruing. It took until 2001 to work through that excess. Conversely, over the last ten years, the world has produced less oil than it has consumed. This is in stark contrast to the 1970s supply shocks, and both demand and supply play a part.

Emerging markets now account for approximately half of the world's oil consumption. This is up from one-third in 1980 and represents an important inflection point. Non-OECD countries' demand for oil is in ascension, growing at an average rate of 4% per annum over the last ten years. Rising incomes, population growth, and industrial output have led to increasing oil intensity. China saw record imports as recently as July despite its economic slowdown. Auto sales continue to grow at double digit rates propelling a shift in oil consumption from diesel to gasoline. All in all, the picture for global oil demand remains positive with potential upside surprises coming from a recovering Eurozone or a faster than expected U.S. acceleration.

Now to the supply side. The nature of today's marginal cost curve also differs mightily from that of the 1970s. Back then, the cost to produce the marginal barrel of oil was less than $20 (in 2012 dollars). As a consequence, oil producers had an economic incentive to supply oil until prices fell back to $20 per barrel. Bernstein Research estimates that today's marginal cost approaches $95 per barrel. This suggests that any move in oil prices below that level will result in supply (particularly new supply) being mothballed until an equilibrium is reached. That is exactly what occurred during the global recession of 2009. When oil prices plummeted to less than $70 per barrel, drilling activity in the U.S. shale contracted by 40%. Supply was cut, and the price mechanism sent oil back to $100 a barrel quickly.

Why has the marginal cost of production increased? Today, new supplies of oil come from complex geology: in deep water offshore or in unconventional onshore locations like shale rock and oil sands. Large amounts of capital are required for any of these. There has been a massive surge in industry capital spending since 2001.

Moreover, the rates at which these new wells decline over time are much higher (15–40% p.a.) than those of older, more mature wells (10% or less p.a.). According to Richmond Energy Partners, the success rate on new wells has fallen to 33% from 41% in 2009. Energy companies are spending more to tap inferior reservoirs that deplete faster and pay back less.

Adding all of this together paints a picture of a market structurally balanced in favour of oil at $100 a barrel or thereabouts. Even if, as oil bears contend, the U.S. shale revolution adds another 2 million barrels to daily production by 2015 (estimated by Bernstein Research), this represents only 2% of total current supply and is easily absorbed by an estimated incremental demand of 4 million barrels from non-OECD countries over the same time period. With the rest of the non-OPEC world experiencing production declines in maturing fields, supply is more likely to underwhelm than overwhelm.

Without a retreat in oil prices, energy companies are unlikely to slow their capital investment anytime soon. According to Pareto Securities, since 2001 most exploration and production companies have produced more oil than they have found—an unhealthy dynamic for publicly traded companies with shareholders demanding growth. Chart 3 highlights the pattern of negative growth in proven reserves for some of the world's largest oil producers.

These companies, encouraged by high oil prices, will continue to spend their available cash in order to replenish reserves.

Against this backdrop, we have invested in a number of stocks in the energy space. All three are services businesses rather than producers, mostly because that is where we have found the most value. Owning services businesses also allows us to collect a toll on industry activity, rather than having to worry about reserve depletion and the profitability or otherwise of exploration spend.

Three niche oil services companies

Reserving the option to purchase more stock in the near future, the following paragraphs will discuss the general nature of these opportunities but will avoid naming names.

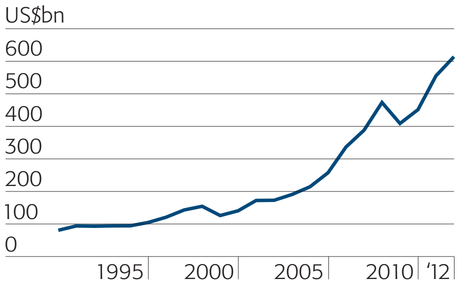
One obvious beneficiary of increased upstream, or exploration, activity is the offshore drilling sector. Exploration and production companies will continue to drill as long as they can earn attractive rates of return and, in the current environment, that makes for a busy market. Rig utilisation is very high around the world, and contracted daily rates are healthy.

The Fund has invested in one stock in this sector paying a dividend yield in excess of 20%. The shares are very thinly traded which helps explain its discounted price. Positive attributes include stable cash flow stemming from a contracted rig fleet, a low cost of marginal production, which helps insulate it against movements in oil prices, and a savvy, opportunistic management team. It's far from risk-free—there is no doubt returns like these will lure new competition and drive returns down—but a healthy flow of cash back to shareholders over the next few years will diminish much of the risk for today's purchaser.

A second opportunity has been found in the seismic services sector. Seismic service companies operate sophisticated marine vessels that produce topographic maps of the seabed that aid in the discovery and production of hydrocarbons. Amid a group of stocks nobody likes (energy), seismic represents the most out of favour. Sector-wide share prices are down 20% year to date and trade on an average price earnings ratio (PER) of 8.5. This has occurred despite the industry growing revenue and earnings. Demand is historically closely linked to oil prices and industry investment, but current valuations have broken that link and seem to forecast a complete decimation of the industry. Bearish expectations generally offer the biggest bargains, and we have focused our attention on a company with a strong management team and a healthy balance sheet. While the short term may prove erratic, the drivers of long-term earnings growth look solid.

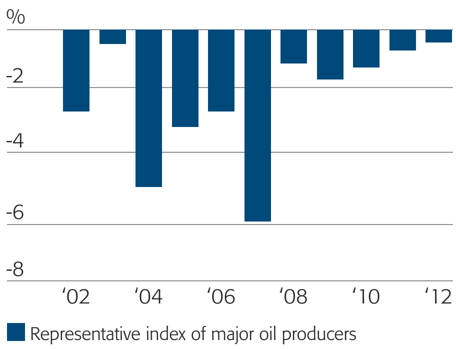
The third (and final) nameless investment comes from a more obscure corner of the energy world. By adding data from their own base stations to publicly available satellite data, GPS system providers allow marine vessels to be positioned with an accuracy of as high as 10cm. For a surface vessel trying to drill a hole in the sea bed or hold still

CHART 2: GLOBAL E&P UPSTREAM CAPEX SPENDING



Source: Barclays Equity Research

CHART 3: GROWTH IN TOTAL PROVEN RESERVES



Source: Intelligent Investor Funds

> *If an ill-found shift in sentiment allows good stocks to get unfairly penalised for not being the flavour of the month, even bottom-up investors can become thematic.*

while oil is pumped to the surface, these systems are 'mission critical' and require a high degree of accuracy. Unreliable positioning data can create severe consequences and cost companies significant time and money. Only three firms in the world provide this service, and strong barriers to entry protect them against new competition. The industry is small in scale and represents a tiny blip on the overall energy map. We have invested some of your money in one of the three and believe the company will benefit from many of the themes discussed earlier.

In total, the International Fund has approximately 10% of its assets invested in the sector.

TABLE 4: FUND CURRENCY EXPOSURE

CURRENC	EXPOSURE (% OF PORTFOLIO)
USD	55.2%
EUR	11.5%
NOK	9.9%
CHF	6.1%
GBP	6.1%
JPY	4.1%
AUD	3.4%
OTHER	3.6%

TABLE 5: SUMMARY OF HOLDINGS

STOCK	COUNTRY	PORTFOLIO WEIGHTING
B&C SPEAKERS	Italy	7.9%
AMERICAN INT'L GROUP	US	7.6%
GOOGLE INC CLASS A SHARES	US	6.6%
AMERICAN EXPRESS CO	US	4.8%
JAPANESE PORTFOLIO OF NET-NETS	Japan	4.1%

Ben Graham bargains in Japan

The father of value investing, Ben Graham, was never as comfortable as when he owned a broadly diversified portfolio of stocks trading well below net working capital (cash, inventory and receivables less all liabilities), or what he called 'net-nets'. This ridiculously strict definition of hard asset value completely ignored long term assets like property and machinery (but not any debts attached to them). Graham himself described it as a penchant for stocks 'worth more dead than alive'. It worked well:

> *'It always seemed, and still seems, ridiculously simple to say that if one can acquire a diversified group of common stocks at a price less than the applicable net current assets alone—after deducting all prior claims, and counting as zero the fixed and other assets—the results should be quite satisfactory. They were so in our experience, for more than 30 years.'*

Value investors intuitively understand why net-nets are an attractive proposition. The problem is that as markets have become more efficient, net-nets have been absent from most stockmarkets for most of the past 50 years. Japan is a clear and present exception. The country experienced a monumental boom and subsequent 25-year bust that was quite reminiscent of the post-1929 decades in which Graham revelled. The March 2013 quarterly update outlined a portfolio of 25 Japanese net-nets the fund was able to acquire at less than 60% of net working capital (slightly stricter than Graham's definition).

So far, the basket has performed OK, nothing spectacular. It's up 7.9% in local currency terms since mid-March, behind the 15.9% of the marquee stocks of the Nikkei index. It's also appreciated more modestly than the fund as a whole, which is up 18.6% over the same timeframe despite a significant cash weighting. Short term underperformance is nothing but noise, and it would be preferable if the net-net area remained value-laden for a while longer yet.

Of the 25 stocks purchased, the Fund has already received dividends from 22. Most of the companies are generating operating profits. The prices of 16 have risen while nine have fallen. The best and worst performers are displayed in Table 6.

TABLE 6: JAPANESE NET-NETS: OUTPERFORMERS AND UNDERPERFORMERS

STOCK	RETURN SINCE PURCHASE	PRICE-TO-NET WORKING CAPITAL	PRICE TO NTA	DIVIDEND YIELD (%)	PER (X)
KITAKEI CO.	40.6%	0.87	0.53	2.0	10.4
ROLAND CORP.	33.2%	0.73	0.59	0.9	–
MITSUMI ELEC	26.1%	0.85	0.57	0.7	–
FUTABA CORP.	22.9%	0.68	0.44	1.6	–
SANYO ENGINEERING	22.9%	0.59	0.31	2.4	11.5
NAGAHORI CORP.	–6.1%	0.56	0.27	4.0	16.4
SHINKO SHOJI	–7.5%	0.45	0.40	3.5	9.6
HOSIDEN CORP.	–8.4%	0.48	0.36	1.9	8.3
KAWAGISHI BRIDGE	–12.0%	0.59	0.32	1.3	–
FUNAI ELEC.	–16.7%	0.44	0.31	3.3	–

Compared with both net working capital and net tangible assets (which includes long term assets like plant and machinery), the stocks remain very cheap. If the nascent bull

> *" If the nascent bull market in Japan continues, these stocks are potential beneficiaries. Individually, no one stock is a high conviction bet, but a portfolio of 25 such quantitative bargains is statistically very likely to do well over time.*

* MSCI All Country World Index (Investable Market Index)

market in Japan continues, these stocks are potential beneficiaries. Individually, no one stock is a high conviction bet, but a portfolio of 25 such quantitative bargains is statistically very likely to do well over time. While we don't pretend to know each investment intimately, some quick examples might be illustrative.

Nagahori Corporation (TSE:8139) is predominately a manufacturer and wholesaler of jewellery, selling to 500 customers including department stores, jewellery stores and distributors. It's not exactly a rapid grower, but roughly flat sales over the past decade is not a bad result in depressed Japan. The company has been profitable in 9 of those 10 years, and is the sort of business that could see significant growth if Abenomics pulls the country out of its decades-old slump. More alluring than the promise, though, is the immediate value. The stock trades at less than 60% of net working capital—mostly representing inventory—and less than 30% of net tangible asset backing. The stock currently pays a 4.0% dividend yield and trades on a historic price-earnings ratio (PER) of 16.

Tomen Electronics (TSE:7558) is one of a handful of electronics and semiconductor companies in the basket. Sales have risen about 30% (in total) over the past decade, and it's been profitable every year. A lower yen would like be a boost for the company, although it owns assets across Asia as well as in Japan. It trades at about half net working capital—mostly receivables and inventory—and just 42% of NTA. On earnings measurements, the PER is 9 times, while the current dividend yield is 3.6%.

Most of the stocks in the net-net portfolio are fairly small and illiquid—Nagahori Corporation has a market capitalisation of less than $50m and Tomen is one of the larger ones at $200m. This is not a game bigger fund managers can play. And it's even impractical for a small fund like this one to incrementally add to each position as the Fund has grown in size over the past six months. But, with many of the stocks still trading at a large discount to net working capital, and some new stocks entering our filter, the Fund is looking to make a wholesale addition of positions to the net-net basket over the coming weeks. It remains an attractive risk/reward proposition.

> “*Being on three corners of the globe can sometimes be a disadvantage, sometimes an edge.*

Prime opportunity seized

Being on three corners of the globe can sometimes be a disadvantage, sometimes an edge. In mid-September, a well-respected hedge fund released a report into German property owner **Prime Office REIT** (XTRA:PMO)—presumably to influence, one way or another, the vote over a proposed merger with Oaktree-backed unlisted property owner OCM German Real Estate Holding AG. The vote was to be held a week later, on 24 September.

II Funds Vienna spent an afternoon analysing the stock after spotting the report, then passed it over to Sydney for a solid day's analysis. By the time the European market opened the next morning, the merits of this event-driven situation had become obvious and the Fund started buying the stock before it popped up in price.

The case was fairly simple. The proposed merger would make the merged group bigger, probably safer and also bring better management, but would also quite heavily dilute existing Prime Office REIT shareholders (which is what had been weighing down the share price). If the deal fell through, the Fund had bought a small position in a small and indebted property owner at an extremely cheap price (less than half net asset value) and the stock was likely to lift if the deal collapsed.

If the vote rubber stamped the deal (which is how things ultimately transpired), the merged entity would be safer and the stock still very cheap. How cheap will ultimately depend on how a planned capital raising plays out. Potential dilution from the rights issue offer somewhat complicates the calculations, but when it's all done the Fund expects to have acquired what by then will be a quite large, well-managed and adequately financed German property owner at a discount to net asset value in excess of 30%. Should the rights issue be larger or cheaper than expected, the dilution will be greater but the Fund will have the chance to pick up more stock at the discounted price, nullifying the effect.

It wouldn't be surprising if the Prime Office share price rose markedly in the coming months, now that the source of uncertainty has alleviated and the stock is large enough to land on the radar of more fund managers. If it doesn't, though, it's an attractive long term holding.

Value Fund

The Value Fund had an excellent September quarter, returning 17.0% and beating the benchmark All Ordinaries Accumulation Index which returned 10.8%. The gains were all the more pleasing because the Value Fund has little exposure to the material and energy sectors which were the stronger performers in the market.

Ingenia Communities

Retirement property group **Ingenia Communities** made its first appearance in the Value Fund two and a half years ago. Back then it was in a distressed state, with too much debt and underperforming assets, which enabled us to initially buy in at around $0.10, a 62% discount to net asset value.

Despite the turmoil there were promising signs. New manager Simon Owen had been brought in to fix the mess and was making good progress improving occupancy in Australia. He had also resolved to sell a portfolio of United States retirement assets and focus on the domestic portfolio, which presented an interesting opportunity. The US assets were loaded with non-recourse debt, which meant an upswing in asset valuations could add meaningful value whereas a downswing would, at worst, only wipe out our thin sliver of equity.

The situation has worked out better than expected. Ingenia's US assets were sold at a premium to book value, ING forfeited its management rights and offered a discount on unpaid fees and Owen has made substantial improvements to the Australian operations. Occupancy has improved in the struggling rental business. Some rental sites have been renovated and sold. A number of low-cost expansions have been made to existing sites. And the company has made a string of opportunistic acquisitions.

The latest and most aggressive phase of acquisitions involves a venture into the manufactured housing estates (MHE) industry. MHE, similar to caravan parks but catering to permanent residents, have until recently been a profitable but little known business run by local operators. It's an attractive business model. MHE residents purchase their kit-homes through the MHE operator, but don't own the land upon which the house stands. The space is instead rented from the owner.

Rents generate steady cash flow, but the real bonus for the park owners comes from a huge commission on the upfront sale of the manufactured house. For Ingenia, parks can be bought at decent cash flow yields of 9-10% and have plenty of space to add new residential lots, which Owen claims can take the total return from the assets to in excess of 15% per annum. From a standing start, he has now allocated close to 40% of the balance sheet to this space.

There's some risk involved. Changes to the government rental subsidy schemes could make the proposition less attractive to residents, for example. But on the balance of probabilities, we expect that this venture will be very profitable.

Fortunately, we don't have to wait around to get the benefits. Not only has the discount to net asset value disappeared but, as the Chart 1 shows, Ingenia now trades at a remarkable 35% premium to book value.

Ingenia is still badly subscale for a stand-alone property trust. It incurs $8.4m in corporate expenses that are supported by only $230m in tangible book value (adjusted for the recent capital raising). Unitholders are giving up 3.6% of equity each year in fees. To put that in perspective, the rental assets only earn a 9.6% return on book value. The leakage is significant.

Plausible is perhaps the best way to describe the current stockmarket valuation. Healthy returns are possible but a significant portion of the potential upside is already factored into the current price. Ingenia's unit price finished September at $0.47, a return of 38% for the quarter including a 0.5 cent dividend, and it now trades around 4.5 times our original purchase price.

Enero Group

In the August monthly report we remarked that the share price for **Enero Group** had rallied despite it delivering a lackluster result. The rally continued in September. More than 10% of the share register changed hands and the share price closed at $0.62, up 82% for the

TABLE 1: SUMMARY OF RETURNS AT 30 SEP 2013

	INTELLIGENT INVESTOR VALUE FUND	S&P ALL ORDS. ACCUM. INDEX
1 MONTH RETURN	4.77%	2.39%
3 MONTH RETURN	17.04%	10.78%
6 MONTH RETURN	20.99%	7.08%
1 YEAR RETURN	42.68%	23.55%
2 YEAR RETURN (PA)	38.89%	18.34%
3 YEAR RETURN (PA)	22.14%	8.65%
SINCE INCEPTION*(PA)	15.09%	7.55%
PORTFOLIO VALUE	**$40.8m**	

*31 Oct 2009

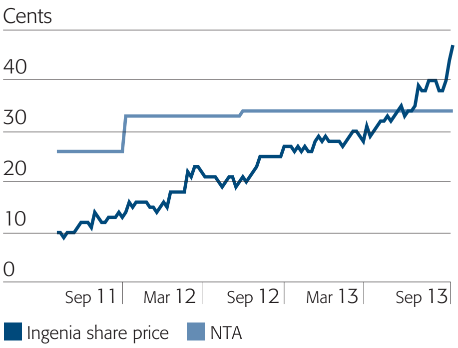
TABLE 2: UNIT PRICE SUMMARY

DATE AS AT	30 Sep 13
BUY PRICE	$1.4373
REDEMPTION PRICE	$1.4259
MID PRICE	$1.4316

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: INA SHARE PRICE AND NTA



Source: Capital IQ

quarter. That's a lot of volume in a company where the two largest shareholders hold 34%.

A takeover offer is a possibility but we've heard no merger or acquisition rumours, nor has any new substantial shareholder shown up. It seems more likely that Enero has simply been reappraised by a more optimistic share market.

Management confirmed that $2.7m in 'tax losses not brought to account' disclosed in the 2013 annual report relates to revenue losses in the Australian operations. This suggests that Australia produced an operating loss of around $9.1m in the 2013 financial year.

Internationally, there's likely a significant loss being incurred from Naked, Enero's combined marketing and management consulting agency. The losses are at least $2m from an investment program announced last year to try and turnaround the struggling agency, and may be much more. The turnaround hasn't gained any traction yet, new agency head Richard Dunmall departed after less than a year in the role and Naked continues to flounder. In an effort to improve results, Enero chief executive Matthew Melhuish now has Naked regional heads in New York, London and Australia reporting directly to him.

Despite the losses in Australia and the international operations of Naked, the overall operating loss was only $3m. The likely reason for the otherwise strong international performance is that Enero's United Kingdom public relations agencies, Hotwire and Frank PR, have been going from strength to strength. In the *Holmes Global 250 Agency Ranking 2013* they came in at 50 and 101 respectively, despite not having significant operations outside the UK. With estimated combined revenue of US$39m they are potentially worth the current market capitalisation of $53m by themselves.

Run Corp

Property agency **Run Corporation** (RNC) is an (unfortunately) small holding in the Value Fund which specialises in leasing management on behalf of residential property owners. Lease management includes services such as advertising for tenants, processing and approving applications, collecting rent and performing inspections. It's pretty standard stuff but actually quite lucrative. The rental management contracts, or 'rent-rolls' as they are known in the industry, generate commissions that grow in line with the underlying growth in rents and, once a business has local scale, the cost of performing the services is low and profits are healthy.

Because rental contracts are so valuable, real estate agents trade them like any other asset; in fact the market for rent-rolls is quite liquid. Run purchased a number of rent-rolls in 2004 and listed on the ASX. The assumption was that they would aggregate the rental contracts that other agents create (usually following a sales transaction) and benefit from the economies of scale available to large operators.

It sounded good in theory, but Run listed with too much debt and never really achieved the scale it needed. A number of initial real estate agency partners decided they would like to keep their rent rolls for themselves. Heavy corporate costs weighed the company down, and dividends were difficult to pay because accounting standards required Run to amortise the cost of purchasing the rent-rolls over their contracted life, despite the likelihood most of these contracts get renewed at no cost. Run's share price fell from $1 at listing to a low of 2.1 cents in 2009.

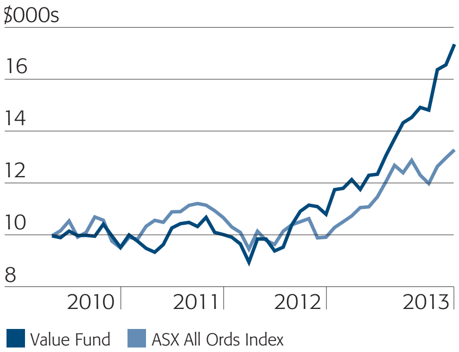
With the stock price so low the company was too small for us to obtain a decent position, and in any case it didn't look obviously cheap as indebted and loss-making as it was. Then, in late 2011, Run managed to refinance its debt at a huge discount, generating a $15m profit and instantaneously converting an unmanageable burden in to something which could be paid off in full within a few years.

Still illiquid, the stock has been difficult to buy in any volume. A spurious takeover offer was made for the company in mid 2012. The stock price rose significantly but gave us access to meaningful volume and still looked cheap, whether or not the deal went though.

As it turns out the takeover deal fell over but the results at Run have improved markedly; it has changed its strategy from a rent-only focus to include a property sales team and is now generating substantial positive cash flow. Debt has been paid down and a fully franked dividend has commenced.

Although only a small holding, Run has delivered a nice return, all of which came in recent months. The shares last traded at $0.32, representing a return including dividends of 71% for the quarter.

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



Source: Capital IQ

> *Enero's United Kingdom public relations agencies, Hotwire and Frank PR, have been going from strength to strength.*

TABLE 4: PORTFOLIO DISTRIBUTION ACCORDING TO MARKET CAP

$0–$100M	38.0%
$100–$200M	30.8%
$200–$1000M	15.0%
$1000M+	4.3%
CASH	16.5%
UNLISTED	1.7%

TABLE 5: A SELECTION OF STOCK HOLDINGS

VISION EYE INSTITUTE (VEI)
Ophthalmology clinics around Australia recovering from historical debt burden.
Weighting: 8.3%

ENERO GROUP (EGG)
Global marketing group.
Weighting: 7.9%

GBST HOLDINGS (GBT)
Financial Industry software provider in the UK and Australia.
Weighting: 7.3%

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