Value Fund
Quarterly Report

INTELLIGENT INVESTOR
FUNDS MANAGEMENT

30 JUNE 2012

Value Fund Dodges Bullets

The Intelligent Investor Value Fund's unit price fell 1.0% during the June quarter, compared with a fall of 5.6% in the All Ordinaries Accumulation Index. Unlike the first quarter of this calendar year, there weren't many company specific events that impacted on the Fund's unit price. The relative outperformance was driven by what we didn't own—resources and consumer discretionary stocks—rather than what we did.

The best performing stocks for the quarter were **Rubik Financial**, **1300 Smiles** and **Real Estate Capital Partners USA Property Trust**, while those that detracted from performance included **Photon Group**, **QBE** and **Infigen Energy**.

No sooner had the ink dried on our March Quarterly Report, carrying the headline *US Puts Rocket Under Value Fund*, did the US rocket start to splutter. »

SUMMARY OF RETURNS AS AT 30 JUNE 2012

	IIVF	ALL ORDS. ACCUM. INDEX
1-month return	–2.64%	0.25%
3-month return	–1.03%	–5.64%
6-month return	14.92%	2.86%
1-year return	7.75%	–7.04%
2-year return	6.43% p.a.	2.11% p.a.
Since inception (31 Oct 2009)	3.03% p.a.	–0.19% p.a.
Stocks in portfolio	18	

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CONTACT DETAILS

Responsible entity
Fundhost Limited
Phone +61 2 8223 5400
Email admin@fundhost.com.au
Web www.fundhost.com.au

Investment manager
Intelligent Investor Funds Pty Limited
Phone +61 2 8305 6050
Email admin@iifunds.com.au
Web www.iifunds.com.au

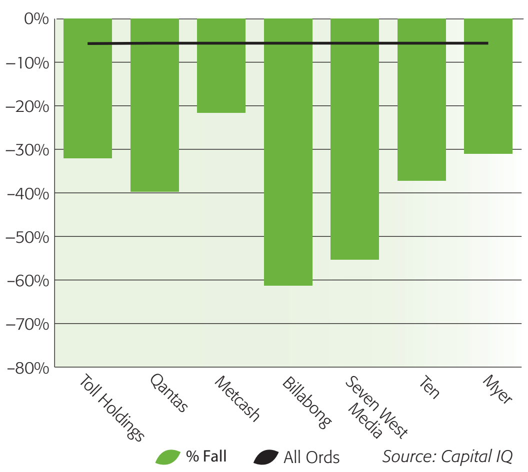
» Employment numbers for the past three months have been poor, less than 100,000 jobs added to the US economy per month on average. Manufacturing, the growth engine of the US economy since the recession of 2009, has slowed considerably. And consumer confidence has taken a tumble.

My macro forecasts, like most others, are clearly not worth the paper they are written on.

Still, we managed to eke out a relatively good quarter thanks to not getting caught in any disaster zones. And there were plenty of those. **Toll Holdings**, **Qantas**, **Metcash**, **Billabong**, **Myer**, **Seven West Media** and **Ten** all announced that this year's profit will fall well short of expectations. They are just the blue chips. There were plenty more at the smaller end of the market and share prices have been punished accordingly. Mr Market isn't in the mood for equities at all, let alone ones that are going to disappoint.

UNIT PRICE SUMMARY
DATE
30 Jun 12
BUY PRICE
$0.9962
REDEMPTION PRICE
$0.9882
MID PRICE
$0.9922

BLUE CHIP STOCK PRICE FALLS (JUNE QUARTER)



In contrast to the early years of the Fund's existence, where we had several significant winners offset by even more significant losers, this past year has been defined by dodging bullets like these. For the year the unit price is up 7.8%. Nothing to retire off but a very acceptable result in a year where the market, including dividends, fell 7.0%.

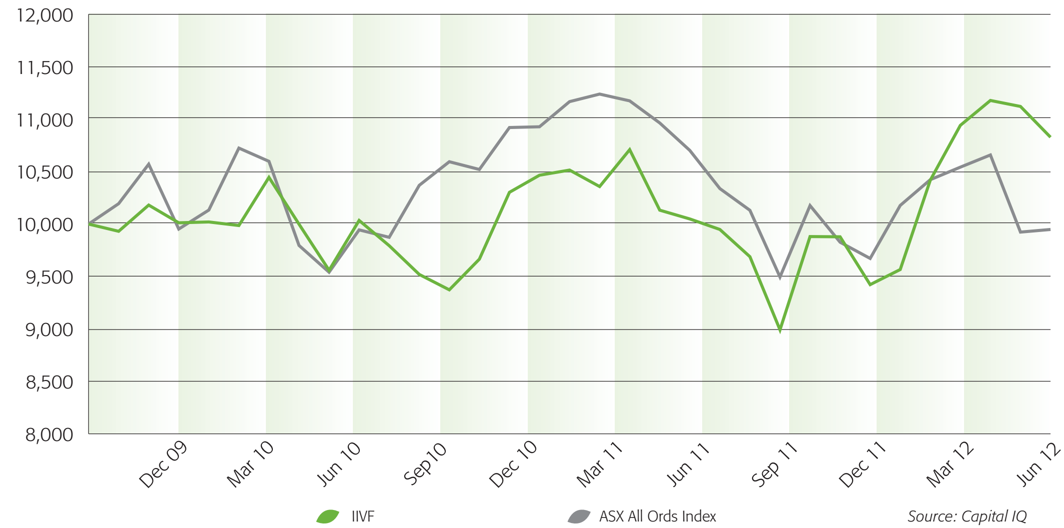
Changing tack when you've been outperforming is not easy. It feels good not owning resources and not owning consumer discretionary when those stocks are getting smashed. But the smugness associated with this feeling is not healthy for future returns. I remember at the depths of the market in March 2009, Jeremy Grantham exhorting those who had held significant amounts of cash through the downturn that their smugness was going to cost them significant amounts of money:

"Those few who look brilliant, oozing cash, will not want to easily give up their brilliance. So almost everyone is watching and waiting with their inertia beginning to set like concrete.

Typically, those with a lot of cash will miss a very large chunk of the market recovery … In June 1933, long before all the banks had failed or unemployment had peaked, the S&P rallied 105% in six months. Similarly, in 1974, it rallied 148% in five months in the UK! How would you have felt then with your large and much beloved cash reserves?"

It was a timely warning, with the US market rallying more than 80% between the date Grantham wrote those words and today. The same applies to sector allocation as it does to cash. There will be a time over the next two decades when owning unloved resources and retail stocks will provide substantial relative performance. Even now, you can buy a former resources darling, **White Energy Corporation**, for

COMPARISON OF $10,000 INVESTED IN VALUE FUND VS ASX ALL ORDINARIES INDEX



Source: Capital IQ

less than the net cash on its balance sheet. There are a number of other resource stocks in a similar situation.

The Value Fund portfolio today, however, is not significantly different from the one we held 12 months ago. We still don't own a resources stock. We still don't own a consumer discretionary stock. We think a lot about the risk of smugness and the potential for returns in today's unloved sectors, particularly retail because we understand it. But, despite its outperformance, we still think our portfolio is undervalued, both absolutely and relatively. In fact, given the events that have taken place at **RNY Property Trust** and Photon Group, it is our belief the value of our portfolio has risen more than the 7.8% that we have made over the past year.

As for resources and retail, the two sectors are at very different points in the cycle. Resources prices, despite having fallen somewhat, have a long way to go if our thesis on China is correct. It's an intensely pro-cyclical industry—very very good in the boom times and very very bad in the busts. We'll be sifting around when distress really sets in but we're not there yet.

Consumer discretionary is already in the doldrums and, if we had to hazard a guess, we'd say that people are going to make money, on average, from these prices. We haven't been able to work out, though, where the value is and, until we do, we'll be sticking with very cheap US commercial property.

Work does not equal profit in the funds management game

Two years ago we went to Townsville to present to potential investors about the Value Fund. While there, I dropped in for a meeting with 1300 Smiles Managing Director Daryl Holmes. We didn't own any stock at the time due to a complete lack of liquidity, but I liked the story. Owner manager, high return on equity, a track record of organic growth as well as the odd acquisition, mostly funded from internal cashflow, keeping the use of debt to a minimum.

As always, there were things to worry about. It was (and still is) a one-man show. The overheads are absurdly low, including a $90,000 salary for Daryl himself, suggesting the margins won't be as high when it comes time to employ a professional management team. And, most importantly, it's a professional services business. The bargaining power, as we've seen with **Photon** and **Vision Eye Institute** for example, lies with the professional and not with the owners of the business.

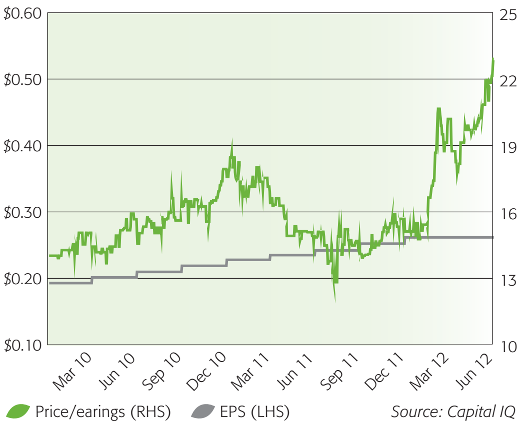
Still, at 15 times earnings and with many years of obvious growth ahead of it, the stock looked reasonably priced.

The meeting with Holmes went well, and at the end I asked him if there was any way we could get some stock. His response—'I'll sell you some'—would normally be cause for concern, but two minutes later we had a deal. Holmes wanted more liquidity on the register, particularly investors who could provide him with capital if he needed it, and I was happy to fill the role. The Value Fund walked out of the meeting with 300,000 ONT shares to its name, bought for $2.90 each.

I speak to Daryl twice a year, after the company announces it's interim and full year results. Those conversations usually last about 20 minutes. We keep an eye on the industry and Daryl's competitors. And we've put some work into our participation in a capital raising. All up, it's probably the stock in the portfolio that we've done the least work on.

1300 Smiles has increased its earnings per share 30% since. On 29 June the share price closed at $5.99. We've collected $0.31 in fully franked dividends along the way for a total return of 117% (43% per annum). It just goes to show that, in investing, sometimes the less work you need to do the better.

1300 SMILES SURGES AHEAD



Source: Capital IQ

Selection of holdings

STOCK	BUSINESS	PORTFOLIO WEIGHTING
AS AT 30 JUNE 2012		
1300 Smiles	A corporate dentistry business located predominately on the east coast of Queensland.	8.5%
QBE Insurance	Australia's largest international general insurance and reinsurance group.	8.1%
Rubik Financial	Financial services software provider.	3.2%

Lessons learned help minimise damage from RCU

Further evidence of the lack of correlation between work and results is provided by **Real Estate Capital Partners USA Property Trust** (RCU), on which we have spent a disproportionate amount of time over the past 12 months only to watch the value vanish before our eyes.

Some mistakes in investing should never be repeated. **Photon** is a good example. The warning signs were there when we first bought the stock. We either missed or ignored them and that has cost us money. There have been lessons learned, and processes improved, that mean we should not make the same mistake again.

Then there are mistakes you make that you fully expect to make again. With the information available at the time, you made the best possible decision, but that decision doesn't work out the way you hoped.

RCU falls into the latter category. While I regret that it hasn't doubled our money as I originally expected, I don't feel that we made a mistake in our analysis at the time.

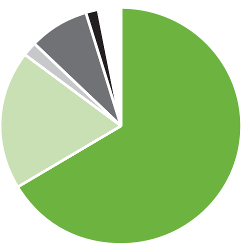
And, since the original investment, we've handled the situation well. We made sure we kept capacity to participate in a capital raising without overstretching the Fund (another lesson from Photon). We've stayed in close contact with other significant unitholders. We have helped stave off a low-ball takeover offer from fellow unitholder Greg Woolley. And now we are leading the charge to replace the manager with someone both better placed and better incentivised to realise the value.

If we are successful with the change of management, we should end up making a small positive return on our overall investment. In any investing, but particularly the style of investing we are practicing, losses are inevitable. As the Photon »

> **"We are leading the charge to replace the manager with someone both better placed and better incentivised to realise the value."**

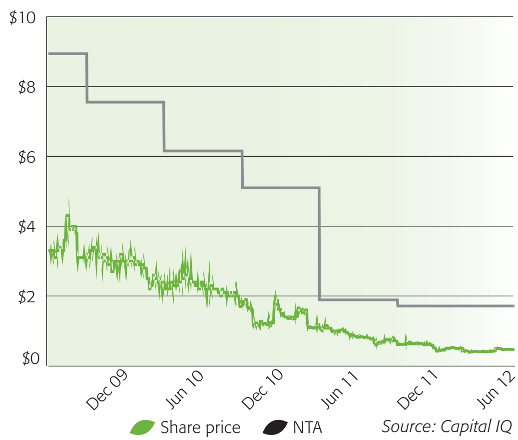
PORTFOLIO DISTRIBUTION (by market capitalisation)

- Less than $100m **66.5%**
- $100m–$200m **18.9%**
- $200m–$1bn **2.0%**
- Over $1bn **8.2%**
- Cash **1.5%**
- Unlisted **2.9%**



and RCU case studies show, the way we react to them, manage them and, ultimately, learn from them can have a significant impact on our returns.

RCU SHARE PRICE VERSUS NTA



Ingenia Jumps Out the Blocks

It was another busy quarter for Ingenia Communities' CEO Simon Owen. In May Ingenia, previously known as ING Real Estate Community Living Group, completed the sale of its last remaining US assets and finalised a separation from its former manager ING, internalisation of management and a name change.

June wasn't much quieter. Ingenia announced the disposal of a 65-unit village in Victoria and a $2 million acquisition in the New South Wales Hunter Region, near an existing Ingenia village.

Transactions like this, though small, are an area where Owen can add a lot of value. Whilst for the major players in retirement living, like **FKP** and **Lend Lease**, these transactions are too small to move the dial, for Ingenia they are an opportunity build scale and earn attractive incremental returns. There is a lot of distressed selling in the retirement space, particularly at the smaller end of the market, and with 11.3 cents per unit coming back to Australia from the US asset sales, Ingenia has plenty of capacity to take advantage of it.

"For Ingenia [these transactions] are an opportunity build scale and earn attractive incremental returns."

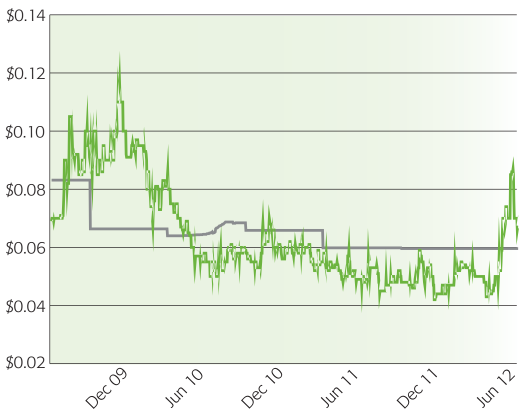
Rubik Swaps Cash for COIN

In 2010, the Fund purchased a small position in banking software provider **Rubik Financial**. Rubik was formed in 2007 through a $32.5 million capital raising, with a plan to form an integrated technology company servicing small Australian banks and credit unions. The idea was that Rubik would consolidate some of the smaller existing technology providers into a group that would offer all the IT services that a bank needed.

Midway through the consolidation process, the global financial crisis struck. Banking regulator APRA then began to require lenders to hold more capital, and in an effort to do so the banking industry has been doing its best to cancel, reduce or defer its major IT projects.

With the outlook bleak for financial services technology companies, Rubik found itself without many attractive acquisition opportunities (vendors apparently clung to the pre-GFC valuation multiples for their companies) having only spent half of their original cash. That was perhaps the best thing that happened to shareholders.

RUBIK: SHARE PRICE VS NET CASH AND LISTED INVESTMENTS



Share price Net cash + investment per share *Source: Capital IQ*

The acquired businesses haven't produced any operating profit and one of its largest acquisitions, a software licence that enables Rubik to offer core banking systems to credit unions and small banks, was written down by $8.5m within 24 months of buying it.

Which is where we came in. Disappointed shareholders were exiting en masse and, by the time we started buying, the share price represented a large discount to the value of its cash. We made a small investment—the risk of the cash being wasted on another acquisition was high—and nothing much happened in the two years since, with interest on cash offsetting the small loss from the operating business and value slowly eroding.

That has changed dramatically in the past three months. First, Rubik announced that a second client had signed up to its core banking service, 'Bank-in-a-Box'. The first was Maleny Credit Union, too small to be a case study. This second client is apparently large enough to ensure everyone else will be watching closely—there are more than 50 small financial institutions that are potential customers for Bank-in-a-Box. Rubik only needs four or five to have a profitable business.

Then in June it announced the purchase of COIN Software Pty Ltd from Macquarie Bank for around $24m, using all of Rubik's cash and some bank debt. COIN provides financial planning and customer relationship management software to institutional clients. We need to learn more about it, but is the type of software that, once entrenched in a »

“Disappointed shareholders were exiting en masse and, by the time we started buying, the share price represented a large discount to the value of its cash.”

business, is very difficult to replace. Some 85% of the revenue is of a recurring nature and the price paid, 4.5 times EBITDA, looks perfectly reasonable. There is a chance this is the value-destroying acquisition we've been worried about. But there is also a chance—higher in our view—that it turns a cash box into a predictable, dividend paying technology company with some growth options to boot.

It's not been a spectacular investment to this point, but Rubik's stock price was up 34% for the quarter and has now increased 22% from our original purchase price. It's going to be an interesting few years ahead.

Wrap up

We're coming up to the Value Fund's three-year anniversary in October and are planning another trip around the country to explain our progress to potential and existing investors. The past 12 months have been excellent and we're hopeful of more good news to report in October, but we require many more years of outperformance to justify our existence.

It would be great to meet you face to face at one of our presentations, so keep your eye out for an invitation around August.

Kind regards,

Steve

2012 Distributions

The 2012 distribution from the Value Fund is 1.8076 cents per unit. The distribution was paid directly to your bank account or, if you elected to reinvest some or all of your distributions, will be added to the number of units you own in the Fund shortly. Please contact Fundhost on 02 8223 5400 if you have any queries about your distribution.

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