Value Fund

Quarterly Update

INTELLIGENT INVESTOR
FUNDS MANAGEMENT

30 MARCH 2012

US Puts Rocket Under Value Fund

The Value Fund's positive performance has been matched by equally positive news.

The quarter ended 30 March 2012 was the Value Fund's best since we began almost two and a half years ago. The Fund's unit price increased 16.1% for the quarter, versus a 9.00% increase in the All Ordinaries Accumulation Index.

Two consecutive quarters of meaningful outperformance leave the Fund well ahead of the index over one and two years and, importantly, 1.6% per annum ahead of the index since inception.

There were a number of stock specific events that contributed to the quarter's strong returns. We discuss **RNY**'s refinancing, a significant return from our »

SUMMARY OF RETURNS AS AT 31 MARCH 2012

	IIVF	ALL ORDS. ACCUM. INDEX
1-month return	5.02%	1.15%
3-month return	16.12%	9.00%
6-month return	21.69%	11.03%
1-year return	5.63%	–6.20%
2-year return	4.67% p.a.	–0.85% p.a.
Since inception (31 Oct 2009)	3.80% p.a.	2.21% p.a.
Stocks in portfolio	17	

CONTENTS

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

» Centrebet investment and further good news from **ING Real Estate Community Living Group** later in the report. But the Fund also benefited more broadly from substantial US-focused investments and a lack of exposure to an increasingly wobbly Australian economy.

Strength in the US, weakness in China

For the past few years, the correlation between the USD/AUD exchange rate and the Dow Jones Industrial Average has been extremely high (0.89 for the stats enthusiasts, which means 89% of the movement in the exchange rate can be explained by movements in the Dow Jones Industrial Average). Every time the US economy shows signs of life, the Dow Jones index rises, and so does the Aussie dollar. The theory presumably being that a strong US economy means a strong global economy and plenty of demand for Australian commodities.

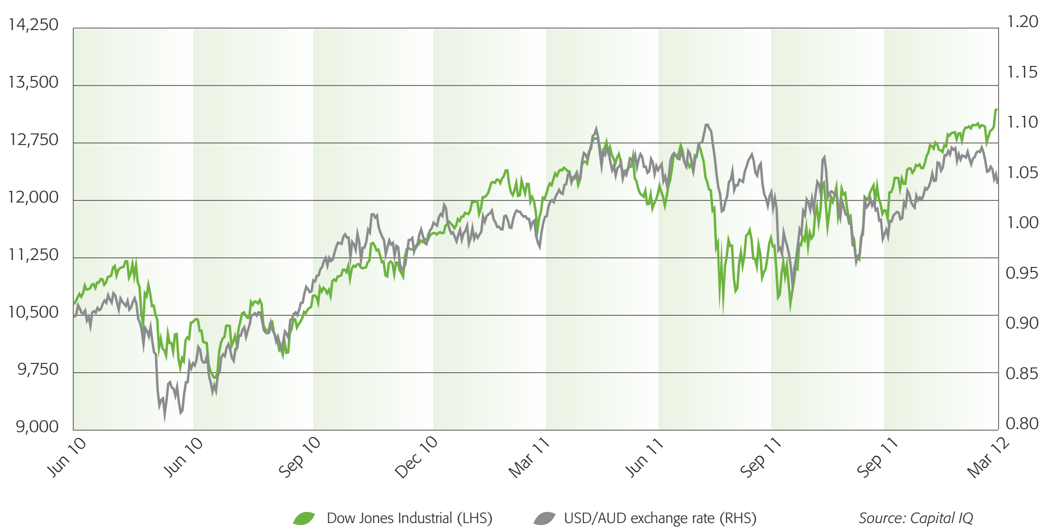
With a large portion of the Value Fund invested in US-exposed stocks, every piece of good news on US employment or GDP has been offset by bad news on the currency front.

The strength of the prior correlation had surprised us. For commodity prices, a strong US economy is minor good news. A slowdown in China is major bad news. As we've been pointing out for more than a year, internal infrastructure spending is far more important to China's economy (more specifically, China's demand for our resources) than exports. So a strong US won't offset a slowdown in infrastructure spending in China.

There is plenty of evidence to suggest the much-

UNIT PRICE SUMMARY
DATE
30 March 12
BUY PRICE
$1.0066
REDEMPTION PRICE
$0.9986
MID PRICE
$1.0026

STOCKS AND CURRENCIES MOVE AS ONE



Selection of holdings

STOCK	BUSINESS	PORTFOLIO WEIGHTING
AS AT 30 MARCH 2012		
ING Community Living	Retirement village owner and operator in Australia and US	10.1%
UXC	Provides information, communication and technology services	6.2%
Mirvac Industrial Trust	Owns a portfolio of industrial property in the Chicago, Illinois area	4.4%
RCU Property Trust	Owns a diversified portfolio of US office property	4.1%

These stocks are not necessarily the largest holdings in the Value Fund.

needed slowdown in debt-funded infrastructure spending is already upon us. In a recent Bloomberg article, JP Morgan analyst Adrian Mowat was quoted as saying "China is in a hard landing. Car sales are down, cement production is down, steel production is down, construction stocks are down. It's not a debate anymore, it's a fact."

All the while, the news out of the US has remained encouragingly positive. The housing sector, a crucial part of the US economy that has been missing in action since the housing bubble burst in 2007, has been showing signs of life. The unemployment rate has been slowly coming down and overall GDP growth has been registering at 2–3%. It's all perfectly consistent with sluggish recoveries from previous debt crisis identified by Rogoff and Reinhart in their book *This Time Is Different*.

With the consumer debt-to-disposable-income ratio down to 113% (from 132% at its peak) and corporate balance sheets in rude health, a return to more normal growth rates is within sight, perhaps within two years.

The implications for Australia of a weak China and a strong US are starting to be reflected in stock prices and exchange rates. During the first quarter of this year, the US stock market has risen while the Aussie dollar has gone down (you can see this clearly for yourself on the far right of the graph). No longer constrained by the correlated dollar, stocks like **QBE** and **CSL**, with significant exposure to the US, have been in demand (the shareholder returns for the quarter were 11% and 12% respectively). In contrast, BHP's share price rose less than 1% during the same period.

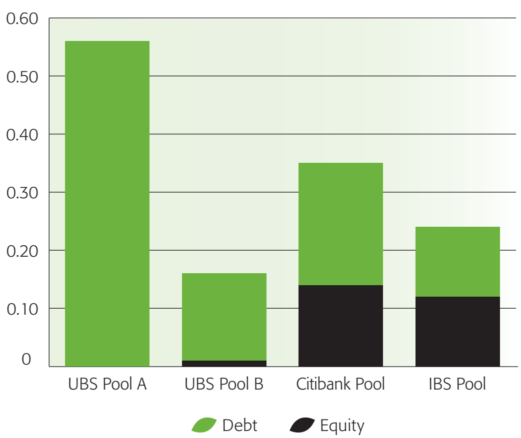
It is, of course, impossible to say with confidence. But I get the feeling we're at an important inflection point. One we're very well prepared for.

> **"It's all perfectly consistent with sluggish recoveries from previous debt crisis identified by Rogoff and Reinhart in their book *This Time Is Different.*"**

RNY on the verge?

As for stock specific news, the most important was provided by **RNY Property Trust** (RNY), an Australian REIT which owns a portfolio of mid-tier office space in the New York tri-state area. RNY announced in February that it had reached agreement on a 'payoff arrangement' for a US$196.1 million loan which expired in September 2010 (UBS Pool A in the accompanying chart).

RNY PROPERTY TRANCHES (USD PER UNIT)



Restating our original investment case, RNY's four debt facilities are limited recourse to four separate pools of property. Two of those pools, conservatively financed with long-term debt, are worth significantly more than the current unit price. Our base case assumption was that, because loan to value ratios were close to 100%, RNY would lose the other two pools of property when the loans came due in 2010.

The recent announcement suggests that we are going to be pleasantly surprised. Based on the notes to RNY's annual report, the 'imminent' payoff arrangement related to UBS Pool A consists of two new loans totaling US$159m—a senior five-year US$123 million loan and five year US$36m mezzanine loan—being used to pay off the existing loan at a discount. Paying off US$196m of old debt with US$159m of new debt creates US$37m of equity out of nothing, 75% of which belongs to RNY.

The mezzanine loan is expensive. The interest rate is 13% and RNY has to pay an additional 15% of any residual cash flow from the properties to the mezzanine note holder. But the weighted average interest rate for both loans is a manageable 7% and, just as importantly, we now have a 5-year option on an improvement in the US commercial property market. A 20% improvement in prices over the five year loan period would add almost $US30m to RNY's net tangible assets on this pool of assets alone (the current market capitalisation is $36m).

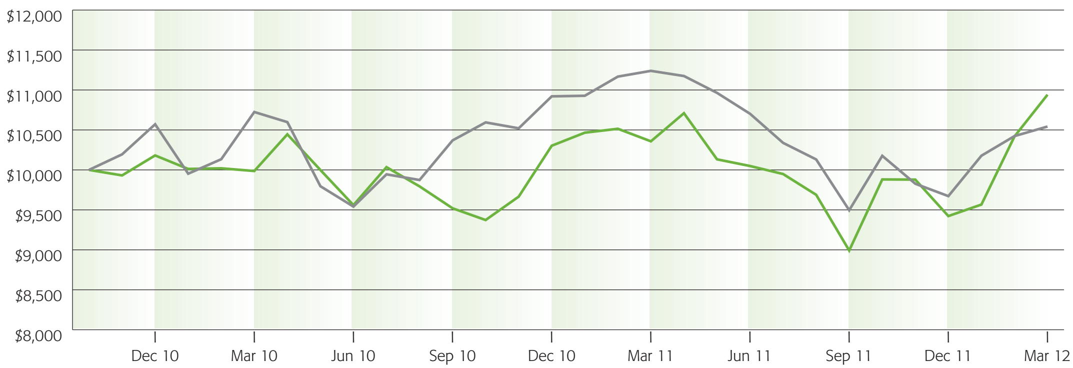
While the unit price rose 41% this quarter, that doesn't seem to reflect the addition to RNY's value from this deal, let alone the fact that it was cheap to begin with.

> **"Paying off US$196m of old debt with US$159m of new debt creates US$37m of equity out of nothing, 75% of which belongs to RNY."**

PORTFOLIO DISTRIBUTION (by market capitalisation)

- Less than $100m **52.8%**
- $100m–$200m **23.9%**
- $200m–$1bn **2.1%**
- Over $1bn **8.8%**
- Cash **9.4%**
- Unlisted **3.0%**

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



Source: Capital IQ

Polar opposite at RCU

The news from our other US property trust showed the difference a management team can make.

While Scott Rechler and his associates at RNY have struck a deal of immense value to unitholders, Andrew Saunders and his team announced another capital raising for Real Estate Capital Partners USA Property Trust (RCU), just 12 months after the last supposedly definitive one. This time a 0.98 for 1 rights issue was to be fully underwritten by RCU largest unitholder, Greg Woolley, meaning Woolley's company, Frost Holdings, will buy every unit not taken up by other unitholders under the rights issue (known as the 'underwriting shortfall'). Given the rights issue was unlikely to be strongly supported by retail investors, the underwriting arrangement effectively delivered control to Woolley without paying the rest of us unitholders a premium. In fact, the $0.40 price at which he would be gaining control is a 61% discount to the post-raising net tangible assets of the trust.

The good news accompanying the rights issue announcement was that **RCU** had agreed a lease extension on its most valuable asset, a US$92.5m property currently leased to RSA Security until December 2016. Albeit at lower rents than would »

"Given the rights issue was unlikely to be strongly supported by retail investors, the underwriting arrangement effectively delivered control to Woolley without paying the rest of us unitholders a premium."

otherwise have been received over the next five years, the lease extension extends the tenancy to 12 years, provides a guarantee from RSA's parent company EMC Corporation (listed on the NYSE) and makes this asset extremely saleable.

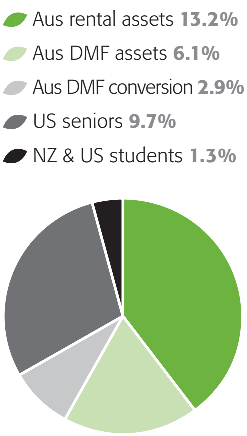
The $17m of net proceeds from the rights issue will enable RCU to provide tenant improvements as part of the abovementioned lease extension and refinance loans due in August this year.

That's all the more reason to be upset that Woolley was attempting to gain control of the trust on the cheap. Fortunately, in conjunction with other major unitholders, we were able to apply to the Takeovers Panel to force RCU to restructure the rights issue so as to mitigate the control impact of allowing Woolley to be the only underwriter.

The Takeovers Panel found in our favour and ordered Woolley to offer all other unitholders a pro-rata share of the underwriting shortfall. We're yet to make a final decision on our participation but if all institutional unitholders participate to the maximum extent possible, it will limit Woolley's ownership to approximately 30%. If retail unitholders take up some of their rights, the impact will be even less, a satisfactory outcome for all involved.

Despite all of the action surrounding RCU, the unit price hardly moved during the quarter, but we expect the impact on our future returns will be significant.

ILF NET TANGIBLE ASSETS (cents per unit)



Dental operator's painless operation

Dental practice operator **1300 Smiles** (ONT) doesn't get much focus in our quarterly reports due to the pain-free and consistent nature of its progress. But it has been one of the most significant positive contributors to our returns since we acquired the stock in the early months of the Fund's existence. Its February results announcement continued that trend, with a 14% increase in earnings per share causing the share price to rise 33% over the quarter. The company now has a market capitalisation of $125m, which brings it onto the radar of a wider group of institutional investors, many of whom seem to have taken an interest in ONT's high profitability and growth prospects.

We share others' optimism about the future and intend on maintaining an investment in this stock for a long time. But the current high interest in the stock also represents an opportunity to realise some profits and redeploy capital elsewhere given the lower discount to intrinsic value and large portfolio weighting. We haven't significantly reduced our position yet due to our reluctance to sell a business with such a clear growth profile ahead of it, but are closely monitoring the trade-off between growth prospects and value on offer.

ILF to become Ingenia

ING Real Estate Community Living Group (ILF) has announced that internalisation will be the preferred option put to unitholders as ING completes its withdrawal from property management in Australia. CEO Simon Owen and other key staff will transition to the internalised group which will be renamed 'Ingenia Communities'.

The name is apparently inspired by 'ingenuity' which in typical corporate drivel 'reflects management's philosophy of operating with resourcefulness and strength'. ILF has indicated $1 million in one-off costs and we expect it to incur higher ongoing management costs as the benefits of ING's scale are lost.

Notwithstanding this, we view internalisation as the right move for ILF; it will allow the interests of unitholders and management to be better aligned and is certainly preferable to ING selling its management rights to another external manager. ING will include sweeteners to the value of $4.1 million (free rent and the like) but otherwise seems intent on collecting on most of its $10.5 million in unpaid fees. Judging by the fall in payables on the December balance sheet, it has already taken a decent chunk.

ILF remains optimistic on the sale of its stake in six New York retirement properties, again indicating that a premium to book value is the likely result, and has also flagged the possibility of distributions recommencing in 2012. ILF closed up 34% for the quarter at 21.5 cents.

Centrebet litigation commences pay out

The tax man has finally paid out on our Centrebet litigation claim securities, which were spun-off as part of Sportingbet's $2-per-share acquisition of Centrebet in August 2011.

At the time of acquisition, Centrebet was involved in a dispute with the Australian Tax Office, claiming tax credits for GST that had been overpaid from the period 2006 to 2010. Under the terms of the Centrebet acquisition, Sportingbet was to distribute the majority of any successful claim to the holders of litigation claim securities.

Having held some Centrebet securities for a few years, we added to our position in Centrebet's final days of trading, based on the view that the market was not ascribing sufficient value to the litigation securities. When Centrebet shares stopped trading at the end of August, the implied value of the litigation rights was $0.24.

The litigation with the tax office has now been settled in Centrebet's favour and the first payment of 13.5 cents was made to security holders during the quarter. We expect approximately 45 cents in further distributions to be received over the next ten years as Sportingbet consumes the tax losses, making for a very successful investment.

QBE's rollercoaster ride

Including dividends, **QBE** shares returned 11% for the quarter. That result, however, belies an unbelievable amount of volatility during the period. Its share price plumbed less than $10 in early January, before increasing more than 40% to end the quarter slightly higher than $14.

In our view the volatility was caused by short-term issues outside the company's control ($300m of losses from floods in Thailand spooked investors early in January). We took advantage of the panic and added significantly to our investment at less than $11, resulting in the total returns to the fund for the month being more than the 11% stock return

> **"QBE is one of the world's best insurance business and, whilst always at the behest of Mother Nature and her violent mood swings, we expect it to earn excellent returns over a three to five year period."**

suggests. QBE is one of the world's best insurance business and, whilst always at the behest of Mother Nature and her violent mood swings, we expect it to earn excellent returns over a three to five year period.

Wrapping up the financial year

One good quarter does not a fund manager make. We are fully cognisant of the fact that our returns since inception are still worse than bank interest and are working hard to ensure we continue the good performance of recent times and avoid the mistakes of our first year of operation.

Encouragingly, despite some of our holdings appreciating substantially, we still have high expectations for the current portfolio and don't see any reason for wholesale changes at the moment. We own some very cheap stocks and some of them have important milestones ahead that should result in at least part of that value being realised.

Our next quarterly report will be delivered in July but we will publish an estimate of the 30 June distribution a few days before year end for those who like to know their tax situation.

As always, please call or email if you have anything you would like to discuss.

Kind regards,

Steve Johnson

INTELLIGENT INVESTOR
FUNDS MANAGEMENT

Disclaimer: This report was prepared by Intelligent Investor Funds Pty Limited, Authorised Representative of Intelligent Investor Publishing Pty Limited AFSL No: 282288. Fundhost Limted (ABN 69 092 517 087) (AFSL No: 233 045) ('Fundhost') as the Responsible Entity is the issuer of the Intelligent Investor Value Fund (ARFN No: 139 641 491). You should obtain and consider a copy of the product disclosure statement relating to the Intelligent Investor Value Fund before acquiring the financial product. You may obtain a product disclosure statement from Fundhost or download a copy at www.iifunds.com.au. To the extent permitted by law, Fundhost Limited and Intelligent Investor Funds Pty Limited, its employees, consultants, advisers, officers and authorised representatives are not liable for any loss or damage arising as a result of reliance placed on the contents of this report.